The New York

Certified Public Accountant

L. XXVI — *January • 1956* — No. 1

The President's Page

National Problems Affecting New York CPAs' Pocketbooks

Federal Income Taxation:

Significant Tax Decisions of 1955
Tax Legislation and Revenue Rulings of 1955
Deferred Compensation Plans
Corporate Reorganizations

Generally Accepted Auditing Standards

Regular Departments

Published Monthly by

THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

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Objects of the Society

"To cultivate, promote and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor and character among certified public accountants; to furnish information regarding accountancy and the practice and methods thereof to its members, and to other persons interested therein, and to the general public, to protect the interests of its members and of the general public with respect to the practice of accountancy; to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States of America; to establish and maintain a library and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects, and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed."

From the Certificate of Incorporation.

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The New York Certified Public Accountant

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Society and Editorial Offices: 677 Fifth Avenue, New York 22, N. Y.

AN ADIRONDACK VIEW

Eggheads are a new species of human beings. They chiefly inhabit the editorial columns of U. S. periodicals. You have never seen one. You have never been told that you were one. And you have never told anyone that he was one—if you had, you perhaps would not be alive to read this.

We looked in the unabridged dictionary for a definition—"egghead" was not listed. Our next attempt to get a definition was with a group of CPA's. They said he was just a plain nitwit. But that wasn't the way "egghead" fitted into the editorials.

So we wrote a Letter To The Editor—it didn't get published. It was just like writing to the Commissioner of Internal Revenue—The Editor is also a large number of persons. But an answer came—"an intellectual, so called because intellectuals are supposed to have egg-shaped heads."

This definition also did not fit the use of this word—in our opinion. Then we woke up and wrote to the horse's mouth—G. & C. Merriam Company, they who keep writing that never finished book, Webster's Dictionary. They gave us the whole story—born in 1952, in Connecticut, is slang; means—"an intellectual; highbrow; usually used disparagingly, implying an impractical idealism."

So another massive problem has been solved. But we still like our original tentative definition, and pass it along to you—"an egghead is a person who has hard-shell ideas that turn out to be soft and gooey when broken open."

Let not this word ever again appear in the literature of any group of certified public accountants.

LEONARD HOUGHTON
"Saranac Lake Branch,
Adirondack Chapter"

Herwood & Herwood

Book Reviews

Montgomery's Federal Taxes, 36th Edition

Prepared by Philip Bardes, James J. Mahon, Jr., John McCullough, Mark E. Richardson and Partners of Lybrand, Ross Bros. & Montgomery. THE RONALD PRESS COMPANY, New York, N. Y., 1955. Pages: xiv + 1024; $15.00.

The 36th Edition of Montgomery's Federal Taxes, in maintaining the high standards of its predecessor volumes, has continued with its stated aim of providing a concise and clear explanation of the provisions of the federal income tax law in the field of business. In accomplishing this basic purpose, the book, of necessity, has avoided repetition of the law and regulations and to a great extent has eliminated the citation of court decisions except where necessary to aid readers in areas of controversy. The use of simple language and the avoidance of technical discussion, wherever possible consistent with accuracy, has made the book readily understandable to the businessman and other individuals not having a detailed familiarity with the tax law and its concepts.

As in the case of the 35th Edition, the book is based entirely on the Internal Revenue Code of 1954. Many changes have been made, however, following the experience of the authors and contributors gained after a year of working with the 1954 Code and from the substantial number of official interpretations during the year.

The book is divided into 22 chapters arranged primarily on a functional basis. This arrangement provides in one place a discussion and distillation of the major tax problems arising out of a particular business situation. For example, a complete discussion of the problems arising out of ownership of natural resources is available under that chapter heading. A major emphasis of the book is on tax planning, with one entire chapter being devoted to the tax-saving possibilities of family and estate planning suggestions applicable to the subject dealt with in the chapter, but suggestions for tax savings are also frequently incorporated into the discussion of a specific subject. Because of the increasing complexity of the tax law, however, provisions of limited impact to taxpayers generally, such as coverage of special taxpayers, specialized procedural rules, and minor exceptions to general rules, have been condensed and restricted.

The arrangement of the book is particularly helpful for quick reference. Chapter titles are descriptive and informative and segregation of topics is marked by descriptive headings which are brought together in a table of contents for each chapter. In

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Book Reviews

(Continued from page 6)

addition, there is a general index at the back of the book, together with tables showing the places where the various sections of the Code and regulations are referred to. The text is also laced with a multitude of cross references both to the Code and other sections of the book. The text is as up to date as possible by means of the inclusion of references to proposed regulations and rulings where official regulations have not been officially promulgated and, as, such is certainly the latest word in current tax law.

William K. Carson

New York, N. Y.

Financial and Administrative Accounting
By C. Aubrey Smith and Jim G. Ashburne. McGraw-Hill Book Company, Inc., New York, N. Y., 1955. Pages: x + 493; $7.00.

This one-volume survey of the accounting field is intended for the use of the banker, credit grantor, business executive, economist and other users of accounting data who are interested in the theoretical structure of accounting, its underlying assumptions and some of its applications.

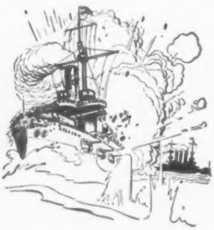
The first nine chapters deal with "financial" accounting, its theoretical foundations, and the preparation, composition, analysis and interpretation of financial statements. The next seven chapters are concerned with "managerial" accounting: internal control, costing, budgets, standards, breakeven analysis and contribution margins. The role of the public accountant in our business society, and a digest of some phases of federal income tax provisions for individuals and corporations are covered in the final four chapters.

The review of the effect of price level changes on financial statements, and some of the discussions on standards and administrative reports may be of general interest; but this volume is too broad in scope to be used as a specialized source by the practicing professional accountant. As a survey of accounting theory and practice however, this book can be a useful college text. For students in the allied fields of business administration, it is an effective means of orientation. It is important for the non-accountant reader of financial statements to understand such underlying assumptions as "going concern" and "money cost", and to realize the effect on income of the method adopted for inventory valuation or depreciation. For the accounting major, this work can serve as the basis of an upper-senior course to integrate the various specialized courses already studied, as well as to re-emphasize basic principles which may have been neglected in favor of the mechanics of assembling accounting data. The problems appearing at the end of each chapter are stimulating for both groups of students.

Richard J. L. Herson

New York, N. Y.

"Those poor devils are dying"



MUSTACHIOED, bulky and calm, Jack Philip stood on the bridge of the U.S.S. *Texas*, watching his gunners pour fire into the Spanish men-of-war fleeing Santiago harbor.

Only a few days before, another American ship had accidentally fired at the *Texas*. Philip had responded by signalling: "Thanks, good line, but a little over."

Now enemy shells were whistling over his head from desperate vessels doomed to destruction. One of them, the Spanish battleship *Vizcaya*, exploded as the *Texas* raced by.

Instantly, a great victorious shout sprang up on the *Texas*. But Captain Philip quickly silenced it:

"Don't cheer, men; those poor devils are dying."

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Van Heusen

THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

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The President's Page

Our National Organization

WHILE we obtain our CPA certificates from the State and many of us practice largely within its borders, we are inescapably members of a profession which knows no State boundaries. This fact has been emphasized by the phenomenal growth of our profession. With that growth has come a corresponding realization of the broader aspects and responsibilities of professional practice. It is no more possible today to practice our profession without regard to the national problems than it would be to conduct our daily lives, except at a routine level, without knowledge of and contact with national and international affairs.

We are indeed fortunate that, as our professsion has expanded, there has grown along with it an outstanding national professional association—The American Institute of Accountants. The purpose of this message is to impress upon our own members that support of and participation in the Institute's program is no less vital a part of their professional lives than is their association with the State Society.

We and the American Institute are not competing, or duplicating organizations. If we were, this message would be unjustified. Years of fruitful association between the Institute and the State Societies, particularly our own, have taught us how to make our services complementary. Where there is slight overlap, it is only in areas where our common interests are so much at stake that service to our profession is enhanced by the joint activities.

The last General Meeting of the New York State Society was devoted to a handful of vital problems of a national character in which our future practice is largely tied up with Institute policy and leadership. On a keynote of "The State Society — Institute Team", there was provided a splendid case history of how the separate but coordinated functions of both groups come together in practice. A large hall was filled beyond capacity. Those present have congratulated the Society on the program and the subject matter. I cite this only as evidence of the growing interest of our membership in national as well as state affairs.

The opportunities for growth in our profession are still tremendous. To capitalize on them, however, we must ourselves grow, for professions are not static. They maintain their prestige only to the extent that the horizons of their underlying members move forward.

I therefore urge those of you who are not already members of the Institute to give serious thought to the opportunities that are afforded by Institute membership. Your membership will support the broad-gauge program on which it is engaged in behalf of your profession.

HAROLD R. CAFFYN,
President

National Problems Affecting New York CPAs' Pocketbooks

The program of the Society's general meeting, held on Monday evening, December 12, 1955, under the chairmanship of President Caffyn, consisted of a prepared discussion of the current status of several down-to-earth problems which are presently being handled for our profession at the national level by the American Institute of Accountants. In the order of their appearance, the speakers were: Arthur B. Foye, past President of the AIA and the Society's First Vice-President; Saul Levy, a past President of the Society and chairman of the Institute's Committee on Accountants' Liability and Liability Insurance; Roger Wellington, chairman of the Institute's Committee on Management Services and of the corresponding Society committee; John L. Carey, Executive Director, AIA; Leslie Mills, a Vice-President of the Society and chairman of the Institute's Committee on Retirement Benefits; and Carman G. Blough, Director of Research, AIA.

The six papers, which are summarized below, indicate clearly the complementary nature of the professional interests and services of the Institute and our State Society. It follows that membership in both the state and national societies should likewise be the normal pattern for all CPAs.

The State Society—American Institute Team

By Arthur B. Foye, C.P.A.

The profession of accounting has been closely tied to the growth of industry in the United States. It is only with the tremendous sweep of industrial development in the past fifty years that accounting has come into its own. Whereas there was a Gross National Product of $30 billion in 1900, we are talking this year in terms of $380 billion. An even more indicative comparison is between the 25 billion kilowatt hours of electric power we generated in 1900 and today's production of close to 600 billion kilowatt hours a year. This is the kind of development that has brought growth to the field of accounting. It is reflected in the birth of accounting schools, so that today there exist 174 of them, with probably 190 to 200 thousand enrolled students.

So it has been with the growth of our State Society and the American Institute of Accountants. Mr. Caffyn has pointed out the similarities between them. I should like to note that there was originally an important difference in their functions. In the early days of the American Institute there was a need for an organization in which membership was an added distinction to being a Certified Public Accountant in one or more states of the Union. It is needless for me to comment on how this concept has changed. This year at the annual meeting of the American Institute, the members there voted to recommend to the whole membership changing the name of the Institute to the "American Institute of Certified Public Accountants."

All of us are accountants, and we know of the tremendous importance of unity in those business organizations with which we deal. We see unity of departments and unity among the subsidiaries which make up the larger corporations. There is great emphasis in business today on assembly of information from all sources, on putting it together in central points and analyzing it there for the benefit of the team.

So it is with the professions. In law there are state, city and county bar associations, and there is the American Bar Association. Perhaps Mr. Carey

may mention this evening that the American Bar Association is conducting a vigorous campaign to bring into its membership the many members of local bar associations so that there may be unity of purpose, thinking and action in the legal profession. If this is desirable in the profession of law, it is even more so in the profession of accounting. Today it is extremely important that there should be a unification of thought on the part of accountants throughout the land. We must have great strength in the national part of the team as well as great complementary strength in the New York State Society and other state societies. Throughout the country everybody is looking to the American Institute for guidance and for stimulating the state societies. Without this over-all unity we can never maintain a position of national leadership in every segment of the accounting field.

So I believe that neither the American Institute nor the state societies will be any less important as a force for growth. I expect that they will work more closely than ever together and that they will be much more unified in personnel, in membership and in planning. It is this kind of over-all teamwork between the state societies and the American Institute that many of us think will be the great bulwark of the accounting profession in the years that lie before us.

Accountant's Legal Responsibility—Where We Stand Today

By Saul Levy, C.P.A.

The most important event in the recent development of accountants' legal responsibility is the so-called *C. I. T.* case. Suit for alleged fraud and negligence was brought against a New York accounting firm by C. I. T. Financial Corporation, a creditor of the accountant's client. In March, 1954, a jury of the Federal District Court found that the accountant's representations were not false or misleading in any material respect. Plaintiff appealed the case, and last June the United States Court of Appeals unanimously affirmed the jury's verdict. In an opinion written by Chief Judge Clark, it also strongly approved Judge Ryan's charge to the jury. This opinion coupled with the charge to the jury, constitutes a new restatement of the law governing accountants' responsibility which is of great significance to all practicing accountants.

In the long-form reports involved in this case, the accountant had disclaimed responsibility for passing on the valuation of collateral underlying the loans receivable which appeared in the balance sheet. The plaintiff claimed that, even if the accountant's opinion was a qualified one, it certified the balance sheet, in which receivables were a material item. On the other hand, the plaintiff further contended that if the value of the loans receivable depended upon the value of the collateral, for which the accountant disclaimed responsibility, then the accountant should have denied an opinion. Thus was raised the question for the jury to decide as part of this complicated case: at what point do you deny an opinion instead of merely qualifying it?

A study of accounting literature revealed that the accountant is responsible for passing judgment on the valuation of collateral since a secured receivable may be worth no more than its underlying collateral. Where collateral is in the form of listed securities, the accountant checks the published market quotations. Where collateral is in the form of inventory, he may discharge his responsibility by securing an expert to appraise it. In performing these audit functions the accountant does not himself act as appraiser. He checks the evidence of independent appraisal by competent experts.

The *C. I. T.* case further represented an unsuccessful attempt by the plaintiff to broaden the scope of accountants' liability to third parties to include mere negligence. The plaintiff was not the accountant's client, but the client's creditor. Plaintiff contended that the accountant knew that this specific creditor would rely on the audit reports and that therefore the case did not come under the *Ultramares* general rule that accountants are liable to third parties for fraud, but not for mere negligence. Judge Ryan's charge stated that an accountant can be liable to third parties for mere negligence only if his report is *primarily* for the benefit of the third party rather than the client. The jury found that the reports were not for the *primary* benefit of the plaintiff.

The Journal of Accountancy rendered outstanding service to the accounting profession by publishing in the October, 1955 issue, substantial excerpts from Judge Ryan's charge to the jury in addition to the opinion of the Court of Appeals. For the rest of our lifetime, Judge Ryan's charge will be cited in defense of accountants under attack. *The Journal* brought to light this judicial pronouncement which might otherwise have been buried in the inaccessible record of the case on appeal.

How to Develop Advisory Services for Your Clients

By Roger Wellington, C.P.A.

CPAs are becoming more and more interested in management services, but they are not yet sure what they mean by the term. Definitions vary from being generally helpful to a client in any way he needs you, to services performed in a special engagement based on specialized knowledge of an industry, office operation and equipment, or particular management techniques. Even without defining the field, however, the trend is toward expanding services outward from an original specialty. This is the usual way the field is entered; for CPAs it frequently means broadening accounting and control services along the general lines followed by the controller in private industry.

The needs of businesses, particularly small ones, for assistance to management are vast and as varied as our definitions of management services. Many need advice in those areas which are closely associated with accounting, where a controller would serve them if they could afford one. Individual CPAs or small firms can equip themselves to meet these needs for their regular audit or tax clients in a limited but effective manner, while larger firms can develop specialists in various areas, techniques or industries.

A first step for a firm interested in entering this field is for the partners to decide whether, on the basis of their own abilities and the needs of their clients, they should approach it through internal uses of accounting—the "controllership approach"—or through specialization in an industry or other field. They will then cultivate their special abilities, personnel policies will be shaped accordingly, and responsibilities assigned within the firm. Research time will be allowed for, and this may not be directly chargeable to clients.

The next step is to review the problems of each present client after the usual audit or tax engagement to detect additional needs. A plan is drawn up covering his needs for improvements and assistance, as a basis for discussing them with him. An understanding is reached as to what might be done for him or how he might be directed to other experts. A preliminary survey may be involved. A program and work schedule is usually prepared. The extent of reporting should be determined as early as possible, and the method of billing agreed upon. Monthly billing is usually advisable because of the difficulty in seeing a stopping point in advance.

The CPA should offer only those services he is qualified to perform. Within this, he is limited only by his own abilities, initiative and public acceptance of his services.

The American Institute of Accountants' committee on management services has undertaken to define this new field, to stimulate professional interest in it and to study educational needs for better fitting future CPAs to provide management services. The committee expects to recommend a program for increasing public awareness of the CPA's qualifications to render constructive advisory services to his clients.

Will the CPA Hold His Tax Practice?

By John L. Carey

Tax work has been estimated to account for a third or more of CPAs' total gross fees. In addition, taxes are often what first bring a businessman to a CPA. Later he may see that he needs auditing and other accounting services.

CPAs have already lost some of their tax practice. Twenty years ago they had very little competition. Now they have been effectively cut off from the U. S. Tax Court and the tax commissions of several states. The *Bercu, Conway* and *Agran* cases have resulted in court judgments limiting the scope of non-lawyers' service in tax advice, preparation of returns and practice before the Treasury Department. Some bar association committees have actively encouraged these developments, as part of what seems to be a conscious plan.

Many CPAs feel that these restrictions don't apply to them. They have encountered no resistance or curtailment of their own tax practices. Why should they worry about the problem? Here are some reasons:

1. If you disagree with your client about your fee, his lawyer may advise him not to pay, on the ground that you were practicing illegally. There have been many instances of this kind, including a number in New York. As word gets around, CPAs may encounter more and more resistance of this nature.
2. According to bar association spokesmen, if your client suffers a loss on a tax matter due to your mistake, he may sue you for recovery of the loss on the ground that you engaged in illegal practice of the law.
3. Businessmen don't like to get involved in trouble and risk. The more lawyers talk about this subject the more businessmen hear of it. If they begin to doubt whether CPAs' tax practice is strictly "legal", they may turn to lawyers, even though it costs more.
4. More and more lawyers are now training for tax practice. More than 20 per cent of the present graduating class in the Harvard Law School plan to go into it.

There will probably be no sudden change, but if CPAs are to hold their tax practice indefinitely they must organize, plan, work, and fight, if necessary. We hope, after two years of discussion, that the Treasury Department will soon clarify the right of CPAs to practice before it, which was challenged by the *Agran* decision. But it may ultimately be necessary to ask Congress to act. The Institute may have to help fight recurring cases in the state courts. We will, of course, keep negotiating with the Bar, in an effort to settle the matter amicably. If there is still no settlement, we may have to seek the support of public opinion with a program beyond the scale of anything we have ever dreamed of.

In the long run the problem can only be solved in terms of what is best for the public. We believe the public will be best served in tax matters by pre-

serving the present generally accepted practice by CPAs. We think most lawyers now see this and accept CPAs on a basis of equality. Ultimately, we hope, the bar association will concur.

Meanwhile, the profession must work on two fronts: first, to continue its constructive program for building public confidence and prestige, through raising ethical and professional standards, continuing education, public service, and similar activities; and secondly, it must be continually in readiness to defend itself in the courts, before the Treasury, in Congress and before the bar of public opinion, if necessary.

If the New York State Society and the American Institute of Accountants had not been as well organized and financed as they were in the last 15 years, CPAs would have lost more of their tax practice than they have. If they are not well organized and financed in the next 10 years, CPAs may lose more of their tax practice than they have.

The problem deserves the study and active interest of every certified public accountant.

Is the Practicing CPA Going to Get Retirement Security?

By Leslie Mills, C.P.A.

When one considers that our tax laws permit tax-free retirement funds to be set aside for employees, but not for the country's ten million self-employed, it is clear that the self-employed are discriminated against. Actually, they are discriminated against twice. First, they cannot deduct from current income their contributions to pension funds. Secondly, since corporations contributed in 1954 about $5 billion to pension plans, which represented untaxed compensation to employees, the self-employed had to help make up the revenue loss.

Every major revenue act since 1942 has extended opportunities for tax deferment and fringe benefits—but exclusively for employees. In 1955, for the first time, proposals for legislation to correct this discrimination got somewhere. In 1956, we have an opportunity to take a real step forward. Last June, we testified at the two-day hearings conducted on two bills (HR 9 and HR 10—one sponsored by a Republican and one by a Democrat) by the House Ways and Means Committee. The vote was two-thirds in favor, and the bill will go to the House in 1956

This is the first time, after five years of effort, that a vote has been taken on the principles we are supporting. Actually, most people have been in favor of them all along, in theory, at least. They have been adopted as planks in the platforms of both major parties, and President Eisenhower has supported them.

The opposition comes chiefly from these four practical and perfectly reasonable considerations:

1. *Philosophical*—It is time to stop tinkering with the tax laws for the benefit of special groups.
2. *Technical*—Questions of coverage and administration of pension funds have caused troublesome debate and countless redrafts of the bills, each carrying opposition groups in and out of the fray.
3. *Selfish*—Large investment funds are involved in pension plans, so that banks, investment trusts, insurance companies, and so on, are competing for them and therefore oppose some forms of legislation.
4. *Practical*—The Treasury Department feels it cannot afford to lose the revenue involved, which is estimated at between $100 million and $275 million a year, if only the self-employed are covered.

The bill as it now stands provides, in essence, that tax-deductible pension funds can be set up for CPAs practicing individually or as partners, but not for their employees. Self-employed CPAs will be able to set aside before tax 10% of earnings annually, but not over $5,000 for any year or $100,000 during life, the tax to fall when the funds and accumulations are taken down. But to get the advantages, the funds must be set aside irrevocably; they cannot be borrowed on, assigned, or drawn down except in the case of permanent disability. These are much more severe restrictions than are found in employee-benefit plans, as are the dollar limitations which probably limit the retirement pension to no more than $8,000 a year under maximum conditions. Nevertheless, it is a step in the right direction and I hope you work for it.

Credit Grantors as Advocates of Audits by CPAs

By Carman G. Blough, C.P.A.

In the case of large corporations registered with the Securities Exchange Commission, audits by independent accountants are required by law, but audits are not required of most smaller businesses unless credit grantors ask for them. Bankers used to decide credit risks largely on the basis of personal judgment of the applicant's character and business, which was possible in a less complicated, small-town economy. Today they are finding this harder, yet many bankers have not learned how they can get assistance.

For some time, joint meetings of the state societies and the American Institute with representatives of bankers organizations seldom produced a meeting of minds. But more recently they have helped to make bankers more aware of the CPA and his audit as a source of help in determining credit risks. While there is still much resistance among bankers to requesting audited statements, it is disappearing. These meetings are helping bankers to understand the meaning of an audit and the audit report, as well as the limits of an auditor's responsibilities.

Other steps are helping in this educational process. Surveys of bankers showed not only that many of them misunderstood the nature and purpose of an audit, but that many others were in need of a clear explanation of an audit which they could use for training purposes. To meet that need, the Institute published "Audits by Certified Public Accountants," which we call "The Red Book." Copies were sent to every bank in the country. More than 500 copies were bought by one bank alone, which sent them to each of its loan officers with a covering letter from a vice president describing it as "must" reading.

As a general rule there have been no accountants on banking school faculties. However, through the influence of the American Institute of Accountants, the American Banking Association has agreed to add lectures on the accountant's responsibility to its curriculum. "The CPA's Opinion" was published by the Institute for use in these schools. Copies were also sent to bankers around the country.

A list of all Institute member firms was also sent to every bank.

In 1953, the Institute with the cooperation of the Robert Morris Associates and a number of State Societies of CPAs completed a survey of more than 7,000 audit reports which had been received by 300 banks in 30 states. The survey helped to show, first, how CPAs were observing the requirements of generally accepted reporting standards and, secondly, it made bankers aware of the kinds of audits they were accepting and the need for tightening their requirements.

Numerous articles prepared or stimulated by the Institute have been pub-

(Continued on page 30)

Significant Federal Tax Decisions of 1955

By Don J. Summa, C.P.A.

THE year 1955, following the widely-heralded changes brought about by the Internal Revenue Code of 1954, has proved to be an important year in Federal income taxation. Many decisions were handed down during the year which, though decided under prior law, continue to be applicable under the Internal Revenue Code of 1954. In addition, certain cases under prior law will be of importance with respect to prior years which have not yet been finally settled. The most significant of the 1955 cases, with a brief indication of their meaning to those concerned with Federal tax matters, are set forth herein.

Taxation of Prepaid Income and Accruals (Reserves) re Estimated Expenses

The repeal of Sections 452 and 462 of the 1954 Code marked an end, it is hoped only temporarily, to one attempt to bring tax accounting and financial accounting more nearly into agreement with each other. Two of the major areas of such disagreement have long been (1) the taxation of amounts collected before they are earned, and (2) the disallowance as deductions of certain reserves, even though related to the production of income in the year for which established.

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The proper tax treatment of prepaid income was considered, in a number of cases, with varying results. In *Beacon Publishing Co.* v. *Comm'r* (CA-10; 1/3/55, reversing 21 TC 610), the Tenth Circuit held that prepaid newspaper subscriptions received by an accrual basis publisher were properly spread over unexpired subscription periods despite the fact that the prepayments were received without any restriction as to their use. It will be interesting to see whether this holding may, in the future, be extended to other areas. The Tax Court has so far, however, refused to go along with this conclusion on the basis that the claim of right doctrine set forth in various earlier decisions, under which the entire amount received is includible in income in the year of receipt, is controlling as to the time when income is taxable. (See, for example, *Curtis R. Andrews,* 23 TC, 1026; 3/15/55).

The Fifth Circuit will have an opportunity to voice its opinion on the analogous question of whether a reserve for the estimated cost of services to be performed in subsequent years may properly result in deferral of income beyond the year when the contract to perform such services is entered into and payment therefor is received. The Tax Court held that this question was essentially the same as that raised in the *Andrews* and *Beacon* cases and again reiterated its disagreement with the Tenth Circuit by disallowing the deduction (*F. W. Schuessler,* 24 TC, No. 28; 5/19/55; pending before CA-5).

In still another case involving the proper time to accrue income and expense, the Ninth Circuit held that income from sales of fruit products and expenses not yet incurred relating thereto were both properly accrued in the year in which the customer was billed, although goods had to be labelled, packed and shipped in a subsequent year, where under industry custom title was held to have passed and this procedure clearly reflected income. An extension of this principle to other estimated expense situations might eventually produce the result which Sec. 462 was intended to permit (*Pacific Grape Products Co.* v. *Comm'r,* CA-9; 2/10/55, reversing 17 TC 1097).

Meanwhile, the Third Circuit ruled that an accrual basis taxpayer could not take a deduction for advertising services contracted for in the taxable year but to be performed in subsequent years where the liability for payment for such services was contingent upon eventual performance (*Harry M. Levin,* CA-3; 1/6/55, affirming 21 TC 996).

Sections 452 and 462 of the 1954 Code were designed to solve some of these problems. However, their repeal early last year leaves us once again in the position where either future judicial decisions or possible Congressional action will be needed to give a final answer.

Other Matters Affecting Timing of Income and Deductions

The time when an economic loss becomes a deductible loss was the subject of several cases decided in 1955.

Two cases involved the write-down of closing inventory to market. In *C-O-Two Fire Equipment Co.* v. *Comm'r* (CA-3; 2/2/55, reversing 22 TC 124), the question raised was whether an optimistic taxpayer is subsequently prevented from claiming a loss for an obsolete inventory as of the date when it, in fact, became obsolete, simply because he tried to use the material bought for his unsuccessful venture by making certain changes in his product in an attempt to keep his market alive. The Court said that it would be unfortunate if efforts made by a taxpayer to use expensive inventory for something other than scrap had to be made at his peril tax-wise, and therefore allowed the deduction. The Court's reasoning was that the taxpayer's efforts were predestined to failure even though he did not know it at the end of his taxable year. In *Amor W. Sharp* (CA-6; 8/19/55, reversing 12 TCM 977 [1953]) the loss resulting from an inventory write-down to market was deductible, despite the possibility that the taxpayer might be reimbursed therefor in a subsequent year, on the basis that the claim was an uncertain one which was not properly accruable at year end. The Commissioner contended that the transaction was not a closed one in view of the taxpayer's right of recoupment, so that the loss was therefore not as yet realized. The Court, however, replied that the method of valuing inventory at the lower of cost or market is an instance where the tax law permits the deduction of an unrealized loss, and is a recognized exception to the general requirement of reflecting in income tax returns only closed transactions.

Other cases disallowed claimed losses resulting from what was essentially the loss of a quasi-monopolistic right. In *Chase Candy Co.* v. *U. S.* (Court of Claims; 11/30/54) the taxpayer claimed a deduction for that part of the purchase price paid for a new business which represented the cost of a right to purchase rationed sugar, maintaining that the discontinuance of sugar rationing had destroyed the value of the right. The Court denied the claim since the taxpayer's right to buy was not destroyed by the removal of rationing, and held that the removal of the monopolistic feature of the rationing law was not an event which

gave rise to a recognized loss. A similar result was reached when a newspaper publisher claimed that a deductible loss was sustained by reason of a change in the by-laws of the Associated Press which resulted in the taxpayer's loss of its exclusive rights to the Association's service in the area in which it was located. This time it was the Tax Court which held that the elimination of the non-competition provision of the original news service contract was not an event establishing the time at which to recognize any decline in value of the contract since the taxpayer had neither sold nor disposed of its Associated Press membership (*Independent Publishing Co.*, TC Memo 1955-274; 10/7/55).

Also on the subject of losses, the Tax Court held that a cash basis taxpayer could properly claim a capital loss only at the time a payment was made on a purchase money note, even though the stock for which the note had been given had become worthless prior to the payment (*Joseph C. Boyer*, 14 TCM 350; 4/27/55).

On the subject of constructive receipt of income, the Third Circuit ruled that dividends were not constructively received by a cash basis taxpayer where the paying savings and loan associations involved customarily mailed dividend checks on December 31 and the taxpayer received them on January 2. It was noted that there was no attempt on the part of the taxpayer to delay or determine the time of payment to him (*Maurice Fox*, CA-3; 12/30/54, affirming 20 TC 1094).

Accounting Methods—Meaning of the Word "Accrued"

Two recent cases in the U. S. Supreme Court dealt with the meaning of the phrase "paid or accrued" as that term was used in the 1939 Code (*U. S.* v. *Olympic Radio and Television, Inc.*, 349 U. S. 232; 5/23/55; *Lewyt Corporation* v. *Comm'r*, 349 U. S. 237; 5/23/55). In the *Olympic* case the Court held that excess profits tax paid by an accrual basis taxpayer in 1946 based on 1945 income did not constitute taxes "paid or accrued" in 1946 for the purpose of computing a net operating loss deduction under former Section 122. The deduction would have been allowable in 1946 only if the taxpayer had kept its books on the cash basis. The Court thus determined that, in the interest of consistency, the phrase "paid or accrued" would be given the same meaning in this section as in other parts of the Code, despite the fact that this interpretation would discriminate in this situation against taxpayers on the accrual basis. The additional issue posed in the *Lewyt* case was whether the tax referred to as having been "accrued" meant (1) the amount of tax based on net income known at the end of the year and arrived at by proper application of recognized accounting principles on the accrual basis, or (2) the amount of tax finally determined to be due after allowing as a deduction a renegotiation refund and a net operating loss carryback from a subsequent year. The majority of the Court felt that the former was the correct interpretation on the theory that the concept "accrued" embodies the annual accounting principle and that adoption of the latter definition would give the word "accrued" a varied meaning, contrary to the policy expressed by the Court in the *Olympic* case.

While the decisions in these cases represent a determination under a relatively obscure section of the former Code, it would appear that in respect to this point they are in basic agreement with earlier cases dealing with the question of the precise meaning of the term "accrued" for tax purposes (see, for example, *Manning* v. *Seeley Tube & Box Co.*, 338 U. S. 561; (1950)). It will be interesting to note what effect the principles underlying such decisions may have on the de-

termination of the time when deductions are properly "accrued," and therefore allowable as tax deductions.

Nature of Income—Capital or Ordinary Gain or Loss

The perennial question of whether a transaction results in ordinary income, capital gain or an adjustment of the tax basis of an investment arose repeatedly in court decisions throughout 1955.

In one case, the question presented was whether losses on futures transactions entered into by a corporation, though not true hedges, should be allowable as ordinary deductions rather than capital losses. The Supreme Court, affirming the Second Circuit, decided that such losses were allowable as ordinary losses since they were incurred as an integral part of the taxpayer's business (*Corn Products Refining Company,* — U. S. — ; 11/7/55).

In two other cases, taxpayers were successful in claiming ordinary losses with respect to dispositions of bonds which were acquired not as investments but as security for the performance of a contract (*Comm'r* v. *The Bagley & Sewall Co.,* CA-2; 4/21/55, affirming 20 TC 983—bonds sold at a loss) or to insure a continued source of supply of raw materials (*Tulane Hardwood Lumber Co.,* 24 TC, No. 129; 9/30/55—bonds became worthless). In each case the loss was considered an ordinary and necessary expense of carrying on the taxpayer's business despite the fact that bonds are not within the explicit statutory exceptions to the definition of capital assets contained in Section 1221 of the Code (old Section 117(a)(1)).

Several other cases dealt with the nature of income arising out of the sale or exchange of mineral payments (that is, the right to receive a specified dollar amount of the proceeds from the extraction and sale of minerals in place until a certain amount has been realized). The Commissioner generally maintains that these transactions result in ordinary income on the theory that they are merely anticipatory assignments of income. Taxpayers, on the other hand, have been successfully contending that what is transferred is, under local law, an interest in realty, the sale or exchange of which results in capital gain. At least three of the decided cases involved oil payments (*John D. Hawn,* 23 TC 516; 12/23/54, pending before CA-5; *Caldwell* v. *Campbell,* CA-5; 1/12/55, reversing DC, N.D. Texas; *Wm. Fleming,* 24 TC, No. 93; 7/29/55, pending before CA-5) and one involved a sulphur payment (*W. F. Weed,* 24 TC, No. 116; 9/22/55). In *Caldwell,* the transfer was a gift to a private charitable foundation while the other cases involved a sale or exchange for a valuable consideration. The taxpayer in *Fleming* exchanged his oil payment for ranch land and claimed that the transaction was nontaxable as an exchange of property of a like kind under Section 112(b)(1) of the 1939 Code (now Section 1031). The Tax Court ruled against him on this issue, holding that a limited mineral interest which expired when a definite sum of money was realized therefrom was not the same kind of property as a fee simple title in realty, and concluded that the transaction should be taxed as a capital gain.

Oil and Gas—Allowance of Depletion Deduction

In addition to the capital gain problem which arises in cases dealing with mineral interests, there exists the further problem of determining who is entitled to the depletion deduction. There is no dispute here that the transferee gets the deduction if he is determined to have a capital investment in the property. However, the factors which determine what constitutes a capital investment, or economic interest, in such property are presently the subject of a dispute which has reached the U. S. Supreme Court.

In one case, the State of California granted the Southwest Exploration Company a lease entitling it to extract oil from submerged off-shore deposits. However, State law required that the wells be drilled on certain upland sites not owned by the Company. The owners of these upland sites granted the Company the right to drill on their land in exchange for a percentage of the net profits from production. The Company took a depletion deduction on all the oil produced, claiming that the upland owners did not obtain an economic interest in the property entitling them to a depletion allowance. The Tax Court and the Ninth Circuit agreed with the Company for a number of reasons, including the fact that the upland owners were never owners of the leased off-shore property and could not have themselves produced any oil therefrom. (*Comm'r* v. *Southwest Exploration Co.*, CA-9; 3/7/55, affirming 18 TC 961; certiorari granted 10/10/55). However, one of the upland owners claimed that it had acquired an economic interest in the oil in place and therefore had become entitled to a depletion allowance. The Court of Claims, disagreeing with the decision in the *Southwest* case, held that, although the upland owner did not own the oil in place or any right to produce it, it did own an interest in the surface of the land of such a nature that no one could economically recover the oil from off-shore deposits without first obtaining from this company the right to use the surface of its land for drilling (*Huntington Beach Co.* v. *U. S.*, Court of Claims; 7/12/55, certiorari granted 10/10/55). The government has persuaded the Supreme Court to review both cases, so that an answer to the problem should soon be forthcoming.

Distributions by Corporations—Taxation as Dividends to Individual Recipients

In 1954 the Courts of Appeals rendered two important decisions in the area of corporate distributions (*Comm'r* v. *Fannie Hirshon Trust,* CA-2; 5/17/54, reversing 12 TCM 364, certiorari denied; *Comm'r* v. *Godley's Estate,* CA-3; 5/28/54, reversing 19 TC 1082, certiorari denied). These two cases (which have since been restricted in their application, as indicated below) concerned property distributions (dividends in kind) made by a corporation whose accumulated and current earnings and profits were in excess of the tax basis of the property distributed but not in excess of the fair market value of the property at the date of the distribution. The Tax Court held that the distribution represented a dividend within the meaning of Section 115(a) of the 1939 Code, and therefore ordinary income to the stockholders only to the extent of the corporation's earnings and profits. The remainder was held to be a return of capital, resulting in an adjustment of basis (or capital gain if in excess of basis). The Courts of Appeals adopted a contrary view to the effect that the property distribution was entirely out of earnings and profits, since those earnings exceeded the cost of the property, and therefore held that the entire distribution was a dividend. They then determined that, since the distribution was a dividend, the stockholders received ordinary dividend income to the extent of the fair market value of the property received (under Section 115(j) of the 1939 Code). The Third Circuit stated that the issue was whether a distribution in kind of appreciated property reduces the distributing corporation's earnings and profits (1) by the fair market of the property without addition to the earnings and profits of the increment in value (as the Tax Court held), or (2) only by the cost of the property (as the Courts of Appeals held).

In 1955 the problem presented in the *Hirshon* and *Godley* cases was the subject of a number of Tax Court decisions. In *George M. Gross* (23

TC 756; 1/31/55, pending before CA-2), taxpayers received cash distributions in excess of the distributing corporation's accumulated or current earnings and profits. They claimed capital gains treatment for the excess amount as a distribution from capital under Section 115(d) of the 1939 Code. The Commissioner argued that 115(d) was not applicable because the capital of the corporation was not impaired, citing *Hirshon* and *Godley,* and maintained that the entire distribution was therefore ordinary dividend income. The Court decided that *Hirshon* and *Godley* were distinguishable because in those cases the entire distributions were classed as dividends (since earnings and profits exceeded the tax basis of the property distributed) and thus 115(d) never came into play. Here, since the distribution was in cash, its "tax basis" was in excess of earnings and profits and thus could not be characterized entirely as a dividend. The excess, therefore, had to be a return of capital under 115(d). The case of *Michael P. Erburu* (23 TC 820; 1/31/55, appeal withdrawn 10/3/55) was decided on the same day as the *Gross* case and concerned the distribution of appreciated property by a corporation having no accumulated or current earnings and profits whatsoever, but rather, a substantial deficit. The taxpayer treated the entire distribution as a return of capital. The Commissioner contended that only that portion of the distribution equaling the cost basis of the property was a return of capital so that the appreciation was taxable as ordinary income to the distributees under the principle of the *Hirshon* and *Godley* cases, since the distribution did not impair the capital of the corporation. The Tax Court again distinguished the earlier cases on the basis that appreciation was taxed in those cases only after the distribution was first characterized as a dividend under Section 115(a) of the 1939 Code, based on the fact that there were earnings and profits in excess of the cost basis of the property. In the present case, the Court held the distribution could not be labelled a dividend even under the *Hirshon* and *Godley* criteria so that the rules regarding the valuation of property "dividends" (which is the authority cited in *Hirshon* and *Godley* for taxing appreciation in those cases) could not be applicable.

Later in 1955, the Tax Court had to decide a case which could not be easily distinguished from *Hirshon* and *Godley.* This case involved corporate distributions of appreciated property over a two-year period. The first year's distributions had a cost basis in excess of accumulated and current earnings and profits and so resembled the *Erburu* case. However, the cost basis of the second year's distributions was less than the current year's earnings and so raised the same issue which was raised in the *Hirshon* and *Godley* cases. The Tax Court decided not to follow the holdings of the Courts of Appeals in *Hirshon* and *Godley* but to adhere to its own opinion in those cases. It held that the distributions in each year constituted a dividend only to the extent of the corporation's accumulated or current earnings and profits and that the balance represented a return of capital (*Harry H. Cloutier* 24 TC, No. 113; 9/19/55).

The newly-promulgated final regulations under Section 316 of the 1954 Code solve in part, for distributions made on or after June 22, 1954, the problem raised in the *Hirshon* and *Godley* cases. This is done by a refusal to follow the rule set forth in those cases, even though the tentative regulations had followed the theory of *Hirshon* and *Godley.* Distributions of property will hereafter be taxable as a dividend only to the extent of earnings and profits, either current or accumulated, of the distributing corporation.

In addition, Section 312 of the 1954 Code provides in part that, upon the distribution of "inventory assets" (in-

cluding unrealized receivables), the earnings and profits of the corporation will be increased by the amount of any unrealized appreciation in such assets. Section 312 also provides for an upward adjustment of earnings and profits where distributions are made at a time when government or government-guaranteed loans in excess of the basis of property securing such loans are outstanding. This provision was designed to overcome the result in cases such as the *Gross* case.

Distributions by Corporations—Effect of Deficit Existing Prior to Reorganization

The problem of determining what constitutes earnings and profits after a combination of separate companies, for the purpose of determining the extent to which a distribution is a dividend or a return of capital, was discussed in *Abraham Snider* (CA-1; 6/22/55, affirming DC Mass.), a case decided under the 1939 Code. The issue was whether or not the deficit of a predecessor corporation may be offset against the earnings of the successor corporation accumulated subsequent to a tax-free reorganization. The Court held that it could be, distinguishing the earlier case of *Comm'r* v. *Phipps* (336 U. S. 410; (1949)). The same result is now required by Section 381(c)(2)(B) of the 1954 Code.

"Thin" Corporations—Debt or Contributions to Capital

In a number of recent cases, the Commissioner has contended that certain transactions between stockholders and their corporations involved contributions to the capital of such corporations rather than debt. In one of these cases the Commissioner was sustained on the basis that the contributions were not made with the intention to create a bona-fide debtor-creditor relationship, though in form the securities were apparently evidences of indebtedness. This happened where the assets of a partnership were transferred to a corporation for debt and capital stock in an obviously unrealistic ratio. The result of the Court's finding was that so-called repayments of principal were taxed as dividends (*Estate of Herbert B. Miller,* 24 TC, No. 103; 8/23/55, pending before CA-9). In some other cases taxpayers were successful, including one in which there was an indicated debt—capital ratio of 2090-1. In that case, the Court held that the book capital did not truly represent the value of the assets transferred and, on the basis of actual value, decided that there was no "thin corporation" (*Sheldon Tauber,* 24 TC, No. 24; 5/9/55). In another case, the Fifth Circuit stated that it was not up to the Court to decide the proper ratio of debt to capital but that Congress could do so if it saw fit (*Comm'r* v. *Rowan,* CA-5; 1/28/55, reversing DC, W. D. Tex.). It will be interesting to see whether any other Courts adopt this theory in the future.

The Fifth Circuit, in another case, permitted a corporation to obtain a stepped-up basis for property sold to it by its sole stockholder, even though the sale had no business purpose other than the saving of taxes; the theory employed was that as long as a sale was genuine it was unnecessary to look at motives, and the fact that it might not be at arm's length only meant that it should be scrutinized carefully to determine whether there was actually a sale. The Court also felt (citing the *Rowan* case) that it made no difference that the capital of the corporation was less than $1,000 and the debt was $125,000. Instead, the criteria used by this Court in determining whether a transaction was a contribution to capital included a determination whether: (1) payments of cash were made for the acquisition of capital assets; (2) certificates of stock were issued; (3) repayment was subordinated to other indebtedness; (4) the maturity date is inordinately postponed; (5) the parties agree not to enforce collection; (6) "interest" is

to be paid out of earnings only; or (7) cash advances are made at the start of the corporate life (*Sun Properties Inc.* v. *U. S.*, CA-5; 3/2/55, reversing DC, S. D. Fla.). The law since 1951 has permitted under certain circumstances a stepped-up basis on such a sale of depreciable property, but in a situation where 80% or more control exists any gain to the transferor is taxed at ordinary rates (Section 1239 of the 1954 Code).

Payments to Widows—Dividends or Gifts

Two recent cases under the 1939 Code emphasize the problems involved in determining whether payments made by corporations to widows of former employees constitute taxable income to the recipient. In *Estate of Arthur W. Hellstrom* (24 TC, No. 101; 8/19/55) payments to a widow who was herself a stockholder, of an amount equivalent to her husband's salary for the remainder of the year in which he died, were treated as a gift even though the payments were made in recognition of services rendered by the deceased and were deducted by the employer. The Court stated the controlling facts to be that (1) the payments were made directly to the wife and not to the estate of the husband; (2) the corporation was under no obligation to pay any additional compensation to the husband; (3) the corporation derived no benefit from the payment; (4) the wife performed no services and the husband had been fully compensated for his services; and (5) the intent of the corporation was to make a gift.

The opposite conclusion was reached, in a somewhat unusual fact situation, in *Ruth T. Lengsfield* (14 TCM 1024; 9/16/15). There the Court, in determining that support payments were dividends, not gifts, placed greater reliance on the fact that the widows were majority stockholders in the family corporation involved. Other factors they relied on included: (1) the deceased husbands had not been valued officers; (2) the payments were not limited and had existed for many years, even extending back to years prior to incorporation when the business was run as a partnership; and (3) there was no showing that the payments had been made in reliance upon the Commissioner's rulings.

The 1954 Code deals with this problem by excluding from gross income employees' death benefits up to $5,000. The extent to which, in reliance on past cases, additional amounts may give rise to allowable deductions for corporations while remaining tax-exempt in the hands of individual recipients may well become the subject of future litigation.

Sale of Employer Corporation's Stock to Employees

The Supreme Court has agreed to review the decision in *Philip J. Lo Bue* (CA-3; 6/9/55, affirming 22 TC 440; certiorari granted 11/14/55). In that case the Court of Appeals agreed with the Tax Court that stock options could be issued to enable an employee to acquire a proprietary interest in the issuing corporation, rather than for the purpose of granting compensation (the issue being one of fact to be decided in each case). If an option is found to be proprietary only, then no income is realized by the option recipient either upon issuance or exercise. The final decision in this case should be of interest in helping to determine the extent that "restricted stock options" under Section 401 of the 1954 Code should be used.

Miscellaneous Matters

Payments received by a corporation pursuant to the "insider profits" provisions of the Securities Exchange Act of 1934 and the Investment Company Act of 1940 have been held by the Supreme Court to be includible in gross income (*General American In-*

vestors Co. v. *Comm'r,* 348 U. S. 434; 3/28/55). Likewise, the Supreme Court has ruled that money received as exemplary damages for fraud or as the punitive two-thirds portion of a treble damage anti-trust recovery must be reported as taxable income (*Comm'r* v. *Glenshaw Glass Co.,* 348 U. S. 426; 3/28/55). The latter decision represented the reversal of a long-standing rule which had been adhered to in the past by various courts.

Expenses to be deductible must be both ordinary and necessary. The Tax Court has held that travel expenses are not necessary expenses of the taxpayer where he is entitled to claim reimbursement for those expenses and fails to do so (*Horace E. Podems,* 24 TC, No. 3; 4/18/55; *Charles N. Kimball,* 14 TCM 1011; 9/12/55).

In determining whether a taxpayer has contributed over half of a dependent's support, the fair rental value of lodging furnished should be taken into account. The Commissioner's contention that only the cost of actual out-of-pocket expenses incurred should be used was denied (*Emil Blarek,* 23 TC 1037; 3/16/55, appeal withdrawn 9/27/55; *William C. Haynes,* 23 TC 1046; 3/21/55, appeal withdrawn 9/27/55).

The tax benefit rule was held not to apply to the recovery of proceeds of a life insurance policy in excess of its basis in the hands of the taxpayer where the policy had been obtained 18 years earlier in partial restitution of funds embezzled by the insured. The Court found that the earlier transfer of assets constituted a closed transaction, since the taxpayer had then relinquished any further claims it had against the insured (*Waynesboro Knitting Co.* v. *Commissioner,* CA-3; 8/29/55, affirming 23 TC 404).

National Problems Affecting New York CPAs' Pocketbooks

(Continued from page 21)

lished in financial bulletins and journals. Statement 23 was published in full by the *Bulletin of the Robert Morris Associates* with an explanation of its significance. Now, in cooperation with the RMA, the Institute is preparing a handbook for loan officers in the form of 40 questions and answers about audit reports.

There are clear signs of progress as a result of these efforts. Dun and Bradstreet now specifies that an audit report may be attached to their credit information form in lieu of filling out the statement form on the blank. If this is not done, but the existence of an auditor's report is indicated, they ask for a copy of his opinion. Some credit grantors are beginning to refuse applications without audits. As more and more applicants for credit are forced to present audits, more and more businesses will come to recognize the significance of an audit and the importance of adherence to auditing standards by the CPA.

Federal Tax Legislation and Revenue Rulings of 1955

By Samuel A. Dyckman, C.P.A.

Part I—Significant Changes In The Tax Law

1955 was not a year of monumental changes in legislative tax policy. It had been anticipated that the 1954 Code would undergo fundamental revisions in the first session of the 84th Congress to correct some of the provisions which were not working out as Congress intended. However, aside from the retroactive repeal of 1954 Code sections 452 and 462, relating to prepaid income and reserves for estimated expenses, the legislative enactments during the year were of limited application. Perhaps when Congress convenes in January, 1956, the time may be more propitious then to study the workings of the new Code which will have been in operation for a year and a half.

There was no single Internal Revenue Act in 1955, but in lieu thereof Congress passed a series of individual acts which sought to amend or change the existing law. The significant enactments are outlined below in a manner to show the effect of any changes made.

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Burden of Proof Rules Applicable to Pending Sec. 102 Cases

Under the new Code, a taxpayer when confronted with a proposed deficiency with respect to having permitted the accumulation of corporate earnings and profits beyond the reasonable needs of the business can file a timely statement explaining the necessity for the accumulation, and thereby automatically shift to the government the burden of proving the accumulation unreasonable. Where the government fails to give the taxpayer notice of the proposed deficiency, with respect to the accumulated earnings tax, the burden is again shifted to the government even though no statement is filed by the taxpayer. These provisions are applicable to taxable years beginning after December 31, 1953 and ending after August 16, 1954. Congress has amended the effective dates to include within the 1954 Code rules all Sec. 102 cases under the 1939 Code provided the proceedings are tried on the merits after August 11, 1955. (P.L. 367.)

Retirement Income Credit for Members of Armed Forces

The 1954 Code provides a limited exemption of "retirement income" in the form of a credit against the tax. For individuals under 65, "retirement income" is defined to include income from pensions or annuities from public retirement systems *other than* systems established by the U. S. for members of the armed forces. The new legislation removes the discrimination against the armed forces effective with respect to taxable years beginning after December 31, 1954. The exception to the definition of public retirement systems has been dropped. (P.L. 299).

Abatement of Tax for Servicemen's Trusts

Sec. 345 of the 1951 Act provided for abatement of tax on the income of trusts which had been accumulated for a member of the armed forces who died after December 7, 1941, and before January 1, 1948. This provision was amended to permit refunds or credits without interest, even though barred by operation of law, (other than closing agreements or compromises), provided claim for such refund or credit is filed before August 9, 1956. (P.L. 310).

Phillipine Residents as Dependents

One of the requirements for a "dependent" who is a citizen or subject of a foreign country is that he be a resident of the U. S., Canada, Mexico, Canal Zone, or the Republic of Panama. The 1954 Code permitted residents of the Phillipines to be claimed as dependents if before May 5, 1946 they were born to or adopted by the taxpayer while he was a member of the U. S. armed forces. The 1955 legislation has changed the crucial date from May 5, 1946 to January 1, 1956, and has extended the benefit of this dependency definition to all open years under the 1939 Code beginning after December 31, 1946 (P.L. 333).

Spreadback of Income from Patent Infringement Suit

Special relief permitting a "spreadback" of income has been available under both the 1939 and 1954 Codes for lump compensation for personal services including income from an artistic work or invention. An award in a civil action for patent infringement has now been included in the "spreadback" provisions for taxable years ending after August 11, 1955. The award can be spread proportionately over the months during which the infringement occurred. (P.L. 366).

Nonrecognition of Gain on Serviceman's Residence

Gain from the sale or exchange of a residence is ordinarily recognized except where a new residence is purchased or constructed within one year of the sale. If constructed, occupancy must occur within 18 months after sale. The 1954 Code suspends the replacement period for members of the armed services on active duty during their induction period, but the extension may not be extended for more than 4 years from date of the sale of the old residence. The 1939 Code also provided for an extension, but not beyond December 31, 1953. Now, by reason of 1955 legislation, servicemen who sold or exchanged their residences prior to 1954 may obtain the full benefits of the 1954 Code provision without the "December 31, 1953" limiting date. (P.L. 384).

Recovery of Amounts Claimed by Another

The 1954 Code grants relief to an individual who is required to restore to another an amount of income of $3,000.00 or more, received in a prior year under a claim of right. The taxpayer has the option of taking the deduction in the year of restoration, or recomputing the tax in the earlier year by excluding the income reported. Relief granted in 1955 extends this principle to a highly specialized situation. Where a deduction of more than $3,000.00 was taken in a prior year by reason of an adverse court decision granting another an award for infringement of a patent, and the decision is later reversed because induced by fraud or undue influence, the recovery need not be included in the current year's income provided the taxpayer elects to adjust the deduction retroactively. (P.L. 384).

Holding Period in Arbitrage Transactions

The "short sale" rules provide that if substantially identical securities are

held "long" for six months or less as of the date of the short sale, the holding period of such substantially identical securities begins on the date the short sale is closed. If the taxpayer entered into an arbitrage operation (which the Service regards as a short sale) at the time he held substantially identical securities "long" for six months or less, he therefore lost the holding period on his "long" stock. The new legislation prevents this loss of holding period as to taxable years ending after August 12, 1955, but only as to clearly identified arbitrage operations entered into after that date. (P.L. 385).

Stockholder's Rent as Personal Holding Co. Income

Both the 1939 and 1954 Codes define personal holding company income as including amounts received as rent from a shareholder owning 25% or more of the corporate stock. Where the rent was received for use of the corporate property in the operation of the stockholder's bona fide commercial or mining operation, the 1950 Revenue Act provided that the rent was to be treated as ordinary rent and not personal holding company income effective for taxable years ending after December 31, 1945 and before January 1, 1950. This relief was continued in the 1954 Code, but only as to 1954 and later years. The new 1955 legislation was passed to remove the personal holding company stigma from rentals of such property to stockholders for the period from 1950 through 1953. (P.L. 370).

Repeal of Sec. 452 and 462

The effect of repeal of the 1954 Code provisions on prepaid income and reserves for estimated expenses was to increase the tax liability for all taxpayers who had elected to adopt the accounting methods provided therein. If the taxpayer had adopted the methods on a return filed prior to June 15, 1955 (when the repeal law was approved), or on a return filed after June 15, 1955 for a taxable year ending on or before such date, he was required to file on or before December 15, 1955 a statement on Form 2175 showing the increase in tax liability resulting from the repeal. (P.L. 74).

Corporate Normal Tax Rate Extended

The reduction in the corporate normal tax rate from 30% to 25% on April 1, 1955 as provided in the new Code was postponed to April 1, 1956. There has been no change in the 22% surtax rate. (P.L. 18).

No Withholding on Noncash Payments to Salesmen

Payments including awards after August 9, 1955 to a retail commission salesman in a medium other than cash for services performed are exempted from the withholding tax. (P.L. 306).

No Withholding on U. S. Citizens in U. S. Possessions

An employer (other than the U. S. government) need no longer withhold any Federal income tax on remuneration paid for services performed by a U. S. citizen in Puerto Rico, the Virgin Islands, and Guam. The employer is required by the law of the possession to withhold local income taxes on the remuneration. The foreign tax credit is, of course, available to the taxpayer to relieve him to a considerable extent from a double tax on the income. (P.L. 321).

Part II—Selected Revenue Rulings

In addition to the technical changes in the tax law there follows a discussion of selected income tax Revenue Rulings of 1955. The rulings have been arranged by topic to permit a logical appraisal and a reference point for further study. In the interests of brevity, no attempt at all-inclusiveness

has been made, but wherever possible, rulings have been grouped for purposes of clarity and easy reference. It should be noted that proposed regulations, not as yet in the definitive stage, have not been reflected in the following discussion.

Lease v. Sale

The Commissioner has set up some broad ground rules in determining whether or not a lease is really a sale of property. These new rules, in conjunction with the new liberal depreciation methods, may make leasing arrangements far less attractive taxwise than in the past. The Service will treat the transaction as a sale if one of the following conditions is present: portions of periodic payments are applicable to an equity to be acquired by lessee; lessee will acquire title upon payment of a stated amount of "rentals"; payments for a short period of use constitutes an inordinately large proportion of the total sales price; "rental" payments materially exceed current rental value; lessee is given the option to purchase at a nominal price; or, some portion of periodic payments is the equivalent of interest. The failure to provide for the transfer of title or the failure to record a conditional sales contract is not controlling. (55-540).

Upon application of these rules, a "lessee" of office equipment was required to treat his payments as capital expenditures recoverable through depreciation where the lease was for a period of 13 years and the equipment had an estimated useful life of from 10 to 15 years. The agreement required the lessee to pay more than 100% of manufacturer's list price, and more than 90% of the total rental in the first 3 years. (55-541). Similarly, a contract for the lease of equipment was considered a conditional sales contract where rentals for 75% of the estimated useful life approximated 82% of the total sales price of the equipment, the total "rentals" were substantially higher than the fair rents, and the lessee was required to pay interest on the unpaid rentals. (55-542).

Casualty Losses

Losses by "fire, storm, shipwreck or other casualty" are deductible. In defining "other casualty" the courts have been insisting that an element of *suddenness* must be present. (Rosenberg, 16TC 1360). An event may have the characteristic of suddenness when it is *unusual* or *unexpected* (Shopmaker, 119 F. Supp 705). In two rulings the Service denied casualty loss deductions for moth damage to a coat (55-327), and for the drying up of a well (55-367), stressing the absence of any element of suddenness.

Sick Pay Exclusion

Up to $100.00 a week of compensation received after 12/31/53 under a wage continuation plan due to illness may be excluded. However, payments for the first seven days of illness are taxable unless the employee is hospitalized for at least one day during his illness. This seven-day waiting period, and the one-day hospitalization requirement is considered as having been met even if they occurred in 1953 for an illness extending into 1954. (55-366). The Acts of Congress providing for leave with pay to civilian employees because of sickness or injury constitute a plan so that such payments, not in excess of $100.00 a week, may be exempt. (55-85). Similarly a hospitalized serviceman may exclude up to $100.00 a week of his pay while convalescing, even if he is required to do light work in the hospital. (55-245). Pregnancy in and of itself is not an illness, but payments for sickness either caused by pregnancy or during a period of pregnancy may be excludible. (55-263). Wages received while absent from work because quarantined on account of illness in family, or because the employee

is required to care for a sick family member are not subject to the exclusion. (55-283).

Alimony

In line with its nonacquiescense in *Eccles* (19 TC 1049) and *Evans* (19 TC 1102), the Service continues to maintain that an interlocutory decree of divorce is sufficient to prevent the spouses from filing a joint return even though under local law such interlocutory decree does not effect a final divorce. (55-178).

Dependents

The 1954 Code provisions qualify as dependents members of a household who make taxpayer's home their principal place of abode. However, this does not include a spouse. A husband cannot therefore claim his wife as a dependent on his separate return. (55-325). If the wife is a nonresident alien, she cannot qualify her husband as a head of a household. But at the same time she will not deprive him of such status if he otherwise qualifies by virtue of residing abroad with a dependent, an unmarried descendant, or an unmarried stepchild. The latter two need not be U. S. citizens nor residents of the United States or a contiguous country. (55-711). A widow who maintains a household which constitutes the principal place of abode of a granddaughter from the date of birth until the end of the taxable year qualifies as a head of a household even though the child is claimed as a dependent by the parent. The widow had paid all of the running expenses of the home occupied by herself, her son, his wife, and the grandchild. (55-329). An adopted child, born in a foreign country, has the citizenship of its parents at the time of its birth. This determines whether the child is a citizen for purposes of the dependency deduction. Legal adoption does not of itself confer upon the child the citizenship of the adopting parents. (55-413).

Medical Expense Deductions

The Commissioner has clarified his stand on what constitutes an expense "incurred primarily for the prevention or alleviation of a physical or mental defect or illness". *Rev. Rul.* 55-261 enumerates as deductible medical expenses: travel and hotel expenses, including meals, and lodging where daily visits are required to a medical clinic (under 1954 Code, Sec. 213, only the travel expense would be deductible, not the food and lodging); cost of a wintertime trip to Florida solely for the benefit of post-operative throat and lung condition; cost of special education or training of a deaf child; cost of regular psychiatric therapy (but not regular instruction) at a specially equipped treatment school; personal counseling for remedial reading if primarily for alleviation of a physical or mental defect or illness; portion of premiums paid on accident and health policies attributable to medical benefits; transportation expense to a doctor's office; cost of air conditioning devices if not part of realty and if used primarily for alleviation of illness; cost of oxygen and oxygen equipment; expenses of operation of an iron lung and related equipment (but cost of construction of a special room for the iron lung, or relocating home heating unit is a non-deductible capital improvement); cost of special mattress and plywood boards for the relief of an arthritic condition; cost of special food and beverages prescribed for specific ailments. Non-deductible items include: transportation expense of a physically disabled person to and from his place of employment; fees paid to a health institute for exercise, rub-downs, etc. not prescribed by a physician; cost of maternity clothing, antiseptic diaper service, wigs, and toothpaste.

Annuity Used to Purchase Property

Neither the courts nor the regulations have resolved the problem as to the determination of the proper basis

to use for property acquired by the issuance of a private annuity to the seller. The Service has finally issued a ruling setting forth comprehensive rules for determining basis for depreciation and for gain or loss on disposition of property acquired by a taxpayer not in the business of issuing annuities. Depreciation prior to the death of the annuitant is taken on the actuarial value of the annuity, or the actual payments made, whichever is greater, while depreciation after the death of the annuitant is on the total payments made. If there is a disposition of property prior to the death of the annuitant, the basis for gain consists of payments made plus the value at date of disposition of prospective payments; the basis for loss consists of actual payments made. When the annuitant dies, additional gain may be recognized, or if the annuitant lives beyond the expected life span, losses will result to the extent of any required additional payments. Where there is a disposition of property after an annuitant's death, the payments actually made constitute the correct basis for gain or loss. (55-119).

Charitable Contributions

Taxpayer, the sole stockholder, as a promotion device had his corporation attach tags to its wares promising a stated amount to a charity chosen by the purchaser. The payments by the stockholder are not charitable contributions. They are in payment of a legal obligation assumed as part of a promotion for his economic benefit. (55-514). Neither are unreimbursed traveling expenses deductible if incurred for a tax-exempt civic league. The only expenses that are deductible are those incurred for charitable and educational institutions, contributions to which would be deductible. (55-151). Similarly, contributions to be deductible must be direct contributions to charitable groups. Payments to a tax exempt but non-charitable organization engaged in promoting sound and economic governmental operations through the distribution of literature to exempt charitable and educational groups would not be deductible even if the payment is earmarked to subsidize the distribution of literature to such groups. (55-269). Although the Code allows deductions for contributions to associations for veterans who have served during wartime, this does not include all veterans' organizations and specifically not reserve officers' associations. (55-156). The Service has revoked 1T3910 and will no longer assert that a farmer or other producer realizes income by making a gift of his product to charity. However, in order to prevent double deductions, the costs applicable to the product are not allowable. Costs incurred in prior years are excluded from opening inventory of the year of gift, or, if deducted in prior years, reduce the amount of contribution. (55-138).

It has long been established that a charitable gift of appreciated property results in no taxable gain to the owner and is deductible at its full market value. (Reg. 118, Sec. 39.23 (o)-1(g)). That principle has now been extended to a charitable pledge satisfied with property which has appreciated in value. There is no taxable gain from the increase in the value of the property before actual payment. (55-410).

Consolidated Returns

Where a parent company is given permission to change from a fiscal year to a calendar year to conform with its subsidiaries (Reg. 129, Sec. 24.14(a)), the group may file a consolidated return for the short period of the parent, but each subsidiary must file separate returns prior to the consolidated short period. Annualization of the consolidated net income is required, (55-80), but the subsidiary's net income for the short period immediately preceding the consolidation, not being attributable to a change in accounting period, need not be annualized. (55-566). A con-

solidated return may be filed even though the subsidiary's stock is held in escrow as security for the purchase price. (55-458). Where an extension of time is desired to file a consolidated return, the parent may file one Form 7004 for the subsidiaries, but the filing of such form is not considered as an exercise of the privilege of making a consolidated return. (55-560).

Stock Redemptions

Generally, a redemption of part of a sole stockholder's common stock, in the absence of a business contraction, is essentially equivalent to a dividend whether the stockholder actually or constructively owns all the shares. The "net effect" of such a partial redemption does not change the essential relationship between the stockholder and the corporation. (55-462).

The 1954 Code treats redemptions like sales if one of four conditions are met: (1) it is not equivalent to a dividend; (2) it is substantially disproportionate and the stockholder after redemption owns less than 50% of the stock; (3) it is in termination of a shareholder's interest; or (4) it is pursuant to a reorganization of railroad corporations.

Where each of two unrelated shareholders owned 50% of the common stock of a corporation, and one owned one share of the preferred and the other 15 shares, the equalization of the preferred stockholdings by a redemption from the second shareholder of 14 shares of its preferred stock was treated by the Service as a sale of stock and not as a taxable dividend. There was no pro-rata distribution in whole or in part effected by the transaction. (55-462). In another ruling, the redemption was held to be equivalent to a dividend. The corporate stock was owned by decedent (999 shares), his wife (one share) and a son (500 shares) who actually operated the business. Under the will, the decedent put his stock in trust with the widow as life beneficiary. The son insisted on full control and the corporation redeemed the trust stock. The Service points out that there were no dividends previously paid; no contraction of business; and the redemption payments approximated the surplus. (55-547). The distribution by a corporation of stock of an 80% subsidiary to its shareholders in order to facilitate the sale of the parent's stock to an interested purchaser, is considered as a device for the distribution of earnings and profits and will not qualify under Sec. 355 of the 1954 Code as a tax-free divisive distribution. (55-103). Without specifying which corporation is deemed to have paid the dividend, the Service held that a sale by a shareholder of his stock in a wholly owned corporation to another wholly owned corporation for the purpose of simplifying the dual operation constitutes a dividend under the 1939 Code. (55-15). Sec. 304 of the 1954 Code specifically covers such sales as redemptions through the use of related corporations.

Corporate Exchanges

An exchange of 54% of the common for new nonvoting preferred redeemable at the corporation's option by stockholders retiring from management, was treated as a nontaxable recapitalization where after the exchange the stockholders had no interest in the corporation either as employee, director, officer or otherwise. (55-112). But where stock of an operating company was transferred to a newly created holding company for debentures and stock, and the holding company stock was donated to a tax exempt charity which in turn liquidated the holding company, assuming liability for the debentures, the exchange was considered taxable on the grounds of no business purpose. (55-36).

Widow's Benefits

The practice of the Service has been to permit an employer to deduct bene-

fits payable to an employee's widow equal to approximately two years salary payments. In *Rev. Rul.* 54-624, it held that an accrual basis taxpayer could take an immediate deduction for the entire amount it "obligated" itself to pay over a future period. In 1955 it modified that ruling by maintaining that widows' pensions are to be treated as deferred compensation payments subject to the limitations of Sec. 23 (p) of the 1939 Code. (Present Sec. 404). That section requires actual payment to permit deductibility of a contribution on compensation under a plan deferring the receipt of compensation regardless of whether taxpayer is on the cash or accrual basis. (55-212).

Net Operating Loss

A net operating loss is the excess of allowable deductions over gross income after giving effect to certain adjustments. One of the required adjustments under both the 1954 and 1939 Codes states that nonbusiness deductions of an individual, other than casualty losses, are allowable only to the extent of nonbusiness income. The Service takes the position that salaries or wages received by a taxpayer constitutes income derived from the operation of a trade or business regularly carried on by him, and is to be so treated in computing a net operating loss. (55-600).

Capital Assets

The Commissioner has insisted that payments by a corporation of debts owed to creditors by its predecessor, an insolvent purchaser, in order to obtain franchises to sell the creditor's products be considered as capital expenditures. (55-332). Likewise the cost of preparing and filing an affidavit of continued use of a trademark, (55-158); the rights and interests in a distributorship agreement with a foreign manufacturer, (55-374); and payment for release of an option to buy assets, (55-557), are to be capitalized. A royalty interest in oil and gas in place, (55-526), and water rights underlying land, (55-295), constitute real property, and if used in a trade or business and held over six months may qualify as Sec. 1231 assets.

Travel Expenses Away from Home

Servicemen stationed overseas are not traveling "away from home" and may not deduct expenses for meals and lodging at their overseas stations even though they are required to maintain homes in the United States for their families who are not permitted to accompany them. (55-571). An employee having two widely separated posts of duty cannot deduct the cost of his meals and lodging at his principal post; he may deduct such costs at his minor or temporary post of duty even though he maintains his family residence at that location. (55-604). Commercial fishermen traveling away from their home port overnight may deduct cost of travel, meals, and lodging incurred, (55-235); however, long line truckers can deduct meals and lodging only while away from their home terminal. Home terminal includes the city or general locality of the beginning or end of the run. Meals purchased in such area are non-deductible personal expenses. (55-236).

Income Producing Expenses

If a wife accompanies her husband on a business trip, her expenses are not deductible unless her presence was directly attributable to her husband's business and was necessary to its conduct. Some incidental services such as taking notes, do not establish the necessity of her presence. (55-57). An investor in independently made movies was denied a deduction for the cost of a European trip to explore new investment possibilities since the taxpayer had no "existing right or interest resulting in the production of income". In line with that approach, preliminary

expenses incurred in locating a boys' camp site and in promoting the business to be acquired are not currently deductible. (55-442).

A subscriber to an investment plan pays an annual custody fee to the sponsor for its investment counsel and record keeping functions. Such fee is deductible as an income producing expense, (55-23) as are payments by an executor to his co-executors for their assistance to him in the performance of his duties. (55-447). However, expenses to increase prestige and reputation, in line with the Tax Court's decision in *Cardozo,* (17 TC3), are nondeductible personal expenses. (55-291). And when a teacher on sabbatical leave traveled and studied abroad, the expenses were nondecutible if such travel and study were not required to maintain the teaching position. (55-412).

It may not be advisable to carry on business entertainment in dry states. The Service holds that the cost of liquor, regardless of where purchased, used for business entertainment in Oklahoma, cannot be deducted as a business expense since to allow it would be contrary to public policy. (55-307).

Involuntary Conversion

Where property is involuntarily converted, the gain on the transaction will be tax free if the property is replaced with property similar or related in service or use to the property so converted and the replacement occurs within a prescribed time. The investment of the funds received on conversion, in a partnership owning and operating similar property is not considered a proper replacement of the converted property, although such an investment in a controlled corporation would be. (55-351). This special tax relief is available to a corporation even if replacement occurs after a decision to liquidate. Where corporate property was involuntarily converted, and the corporation elected to replace the property within the statutory period for nonrecognition of gain, the fact that the corporation subsequently, but before replacement of the property, adopted a plan of liquidation will not preclude nonrecognition of gain provided the replacement is completed on time. (55-517). As to what constitutes an involuntary conversion, the Service maintains that the sale of shares of stock made necessary by a state legislative act is not a transaction consummated under a threat of condemnation. (55-717).

Installment Obligations

Gain or loss results on "disposition" or "satisfaction" of an installment obligation. However, the Service maintains that a modification of an installment contract for the sale of a patent to reduce the selling price and installment payments, does not constitute such a "disposition" or "satisfaction". (55-429). But where a trust, upon termination, distributes installment obligations to the beneficiary, the distribution is a "disposition" at fair market value, and the gain is taxable to the beneficiary. (55-159).

Pension Plans

Despite the fact that the Code refers to a plan covering "employees", a plan may be qualified even though it covers only the employer's one employee. (55-81). A pension plan maintained jointly by more than one employer is not discriminatory merely because the annual compensation used as a basis for determining employee eligibility or benefits is considered as the total received by that employee from all participating employers. There is no objection so long as there is a proper allocation of costs of the resulting benefits among the participating employers. (55-276). Nor will a suspension of contributions be considered discriminatory if there is a provision for full vesting of the employee's rights upon the discontinuance of the contributions. (55-186). The Service will not concern itself with the enforcement of em-

ployee rights under an approved pension plan except to the extent that it must determine whether the plan in its actual operation meets all Code requirements. (55-297).

Contributions to an escrow fund pending union negotiations for establishment of a pension plan and trust are not deductible until the plan is consummated, and the escrow funds are irrevocably turned over to the trustee. Deduction is then permitted if the trust is qualified, or if not qualified, if the employees' rights in the contributions are non-forfeitable. (55-310).

Partnerships

A partner's "guaranteed salary" is income from self-employment despite partnership loss. Such drawings are not a return of capital as they might be if the excess were chargeable to his own capital account. (55-30). An agreement that a partner's capital could be invested in securities chosen by him, income, and gain or loss, to be for his account, does not convert the securities into partnership property for tax purposes. The cost of the securities should be treated as a withdrawal of capital and a personal investment. (55-39).

Dividend Exclusion

For purposes of the dividend exclusion, dividends on stock held by a husband and wife as tenants by the entirety or as joint tenants with equal rights of survivorship, are considered as having been received one half by each. Each may exclude up to $50.00 of such dividends on a joint or separate return, but one spouse may not use any portion of the $50.00 exclusion not used by the other. (55-476).

Gifts and Prizes

The Service has finally admitted that with respect to income tax treatment of gifts of agricultural or manufactured products or property held for sale in the ordinary course of business, the fair market value is not includible in the donor's gross income. However, the property must be removed from the opening inventory and from any current year's costs applicable to the donated property. (55-531). Prizes given by an employer in a sales promotion campaign to the wives of the successful salesmen constitute additional wages to the salesmen. (55-232). An individual who devotes a good deal of his time to entering unrelated prize contests as a hobby need not report the value of the prizes as self-employment income for social security tax purposes. Although winnings are subject to income tax, they do not constitute income from a trade or business. (55-258).

Interest

Interest paid on an indebtedness is deductible unless incurred to purchase or carry tax exempt securities. However, where the indebtedness has been incurred for refinancing other loans, or for working capital and contemplated plant expansion, a temporary investment of the funds in tax exempts will not preclude the deductibility of the interest. (55-389).

Foreign Income

An insurance salesman who is a U. S. citizen may exclude from gross income "first year" and "renewal" commissions on policies written while he was a bona-fide resident abroad, whether the commissions are received before or after his return to the United States. (55-497). Also, where a pension is paid with respect to services rendered by a U. S. citizen while a bona-fide non-resident, the income from such pension is tax exempt. Where only part of the services for which the pension is paid was performed abroad during such period of nonresidence, a proportionate part of the pension is to be excluded. (55-294). If a U. S. citizen residing abroad is qualified to treat all income earned abroad as exempt, he may claim the full amount of medical expenses paid abroad, and the real estate taxes on his foreign residence, as deductions against any income from U. S. sources. (55-191).

Tax Thoughts on Deferred Compensation Plans

By Carl Holzschuher, C.P.A.

A discussion of some of the tax effects of pension and profit-sharing plans and deferred-pay contracts on employers and employees, with particular reference to changes made by the 1954 Revenue Code.

The subject of deferred compensation has become a very popular one in recent years, especially as a means of benefitting officers and key personnel who, because of high individual tax rates, would not be able to retain any appreciable amount of current increases in compensation. Most of these plans are designed to provide financial security after retirement and to defer income into years in which it probably will be taxed at lower rates.

The type of plan adopted by a particular employer should be the one best suited to the needs of the company which will provide the desired benefits for the employees to be covered. The cost of the plan to the company, both at the time it is initiated and in the future, is a major factor to be considered.

This discussion will be limited to recent tax developments affecting pension and annuity plans, profit-sharing plans, and deferred-pay contracts. Of course, the best way to assure a tax deduction for the employer and deferment of income for the employees is to establish a qualified plan.

The 1954 Code made few changes in the requirements for qualification. The requirement still exists that a qualified plan may not discriminate in favor of stockholders, officers, supervisors, or highly compensated employees. It is not, however, necessary to cover all employees. For example, the Code provides that a plan will not be considered discriminatory if it is limited to salaried or clerical employees, employees who have been employed a minimum length of time, not exceeding five years, employees who have reached a certain age, or employees whose salaries are in excess of $4,200. In the latter case, however, it is still necessary that the benefits provided under the plan be integrated with social security benefits.

Using one or more of the above classifications it might be possible in a small company to cover the executives and stockholders without including too many other employees in the plan initially. Of course, provision must be made for other employees to be covered at such time as they meet the eligibility requirements. As an example, I know of a personal holding company which has successfully established a qualified profit-sharing plan which covers three employees of the company, two of whom are officers and stockholders. So long as the contributions or benefits provided under the plan treat the non-officer and non-stockholder employees on an equal basis, there is no reason why this type of plan cannot be used as a means of deferring compensation of the executive employees.

A pension plan generally is more desirable in instances where the objective is to provide definite retirement benefits for the employees. This type of plan requires a more-or-less fixed annual contribution, in order to provide the benefits called for by the plan. While a profit-sharing plan can be designed to serve the same pur-

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pose, the annual contribution is generally based on the profits of the company and can vary from year to year, depending on the results of operations. For this reason, the benefits accruing to a particular employee may be more or less than those which would come from a pension plan. In cases where the top executives are close to the normal retirement age, the benefits to be gained from a profit-sharing plan might not be enough to provide sufficient retirement income.

If there is no intent to provide retirement benefits, a profit-sharing plan can be effectively utilized as a levelling-off device to provide additional compensation in later years when profits may be small or non-existent, and the company is not in a position to pay salaries or bonuses as high as might be paid in profitable years. Many plans do this by providing that the employer's contributions and the increment thereon may be withdrawn by the employees after a certain number of years.

Changes Affecting Employers

The 1954 Code and the proposed Regulations thereunder have made certain changes in the requirements for qualification of plans and the allowance of the contributions as a tax deduction to employers.

The Regulations under the 1939 Code required that a profit-sharing plan must provide a definite predetermined formula for arriving at the amount of the contribution. The proposed Regulations do not contain this requirement, but specify only that the plan must provide a definite predetermined formula for allocating the employer's contribution to the participants and for distributing the accumulated funds.

A further change made in the 1954 Code is that pension and profit-sharing trusts are granted exemption under Section 501, relating to exempt organizations, and thereby become subject to tax on any unrelated business taxable income. Also, in this connection, the trust can lose its tax exempt status if it engages in the prohibited transactions described in Section 503, such as lending money to the employee without adequate security or a reasonable rate of interest, making services available to the employer on a preferential basis, purchasing property from the employer at an excessive price or selling property to the employer at less than a fair price.

A change which benefits accrual-basis taxpayers is the allowance of the deduction in the taxable year to which the contribution applies, if it is paid before the date of filing the return, including extensions of time. Under the 1939 Code, payment had to be made within sixty days after the close of the taxable year.

It is also possible under the new Code for affiliated groups of companies to get a deduction for contributions to a profit-sharing plan for other companies in the group who are prevented from contributing because of a lack of current or accumulated earnings. The companies having current or accumulated earnings are allowed to make up the contribution of the non-earnings companies on a pro rata basis.

Changes Affecting Employees and their Beneficiaries

The most significant changes under the 1954 Code are in the provisions governing the taxation of employees and their beneficiaries upon the receipt of distributions from qualified plans. As under the old Code, the employee pays no tax on benefits from a qualified plan until amounts are distributed or made available to him.

Payments from a non-contributory plan are taxed in their entirety at the time received. Payments from a contributory plan are taxed under the new annuity rules provided in Section 72. For this purpose, the employee's cost for determining the annuity exclusion ratio is the total of his contributions, plus amounts contributed by the employer while the employee was exempt from tax because of foreign

employment and, also, any contributions which were taxable to the employee because they were made during a year in which the trust was not exempt.

If the employee's own contributions to such a plan will be recovered within three years, he will not be taxed on any payments until the full amount of his contributions has been received. After that time, all payments are taxable to him. If the employee dies and his beneficiary receives the payments from the plan on the same basis, the $5,000 of the employer's contribution which is eligible for the death-benefit exclusion under Section 101(b) also forms a part of the cost of the annuity.

Amounts received under qualified plans are also eligible for the new retirement income credit.

As under the 1939 Code, the distribution of an employee's entire interest in a trust on account of death or other separation from service is taxed as a long-term capital gain. This treatment has also been extended to lump-sum distributions from qualified annuity plans. Payment to a beneficiary of an employee's entire remaining interest in the plan upon death after retirement is also taxed as long-term capital gain. The $5,000 death benefit exclusion is available to the beneficiary on such a distribution whether the rights of the employee were forfeitable or non-forfeitable at the time of his death.

Another new provision which is helpful to the beneficiary is contained in Section 2039(c), which provides that amounts due under a qualified plan are not includible in the employee's estate except to the extent of amounts attributable to his own contributions.

On the surface, it might appear that a lump-sum distribution taxable as long-term capital gain would be favorable taxwise to the employee or the beneficiary.

This could, however, produce a higher effective tax than if payments are received over a period of years when other income is not substantial and the recipient is in lower tax brackets. Therefore, it is desirable for the plan to provide an option for the method of distribution so that the employee or beneficiary will receive the income at the time it will be least costly to him taxwise.

Deferred Pay Contracts

Another method of deferring compensation which has become increasingly popular in recent years is the use of deferred-pay contracts. This type of arrangement is not specifically covered in the Code or the Regulations and, therefore, presents some income tax uncertainties at the present time. It is likely that this type of contract will be included in the Code within the next few years inasmuch as consideration was given to it by the House at the time the 1954 Code was enacted.

A contract of this sort generally provides for payments to the employee after retirement or to his widow or other beneficiary for a period of years or for life. The employer gets no immediate tax benefit inasmuch as the amounts are deductible only at the time they are paid. However, the employer does have the advantage of not having to put any money aside during the period of employment and has the use of the cash during that time. On the other hand, the employer might not be in a position to use the tax deduction at the time the payment is made if the business should be operating at a loss at that time. This would also be of concern to the employee if there is a possibility that the employer might not be in a position to make the payments when they become due.

It is essential that contracts of this type be so drawn that there is absolutely no possibility of constructive receipt to the employee at the time the payments are considered to be earned. Some plans are funded by the purchase of an insurance policy or an annuity contract. In cases where this is done, the insurance must be com-

pletely disconnected from the deferred pay contract. The employee can have no rights whatsoever in the insurance contract; otherwise there would be constructive receipt at the time the insurance payments are made.

It is also necessary to provide contingencies which must be fulfilled before the employee is entitled to receive the payments. Most arrangements contain a combination of some or all of the following provisions.

The employee is generally obligated to serve the employer in a certain capacity for a specified number of years or until his retirement at an age provided in the contract. After that time, he is usually required by the agreement to be available for consultation or other services during the period of time in which the payments are to be made. These contracts frequently provide that the employee will not engage in any business competitive to the employer during the time that the payments are made, or that if he does engage in such competition, the payments will cease.

A further contingency which is written into some contracts is that benefits may be reduced or eliminated in any year in which the employee's earnings exceed a specified amount. The contract should state whether business earnings, salaries alone, or income from all sources should be the measure.

It is also possible to relate the amount of the payments to the earnings of the company at the time the payments come due.

If payments are to continue after the employee's death the commuted value of the payments to be received by the beneficiary would be includible in the employee's estate for tax purposes. The payments would be in taxable income when received by the beneficiary, but a deduction would be allowed for the estate tax attributable to the communted value included in the estate. In this instance, the beneficiary would also be entitled to the $5,000 death-benefit exclusion.

Corporate Reorganizations

By Frank M. Budik, C.P.A.

This paper contains a non-technical presentation of tax-free exchanges involving corporations and corporate stock and securities.

Ordinarily an exchange of property, corporate stock or securities for property, stock or securities results in either gross income or a loss for tax purposes. According to the definition in the Internal Revenue Code gross income means all income from whatever source derived.

In many exchanges, there is little or no economic change with respect to the parties involved in the transaction. Because of this continued interest Congress, in the enactment of tax laws, does not require that gain or loss be recognized for tax purposes in certain specified transactions where, in a broad sense, the change in ownership is not of substance but is merely one of form. The Internal Revenue Code permits the postponement of tax in certain types of exchanges which are commonly referred to as tax-free exchanges. There are several exchanges not involving stocks or securities of corporations which are permitted to be made without the recognition of gain or loss. These exchanges are not included in this presentation. The majority of tax-free exchanges pertain to three types of transactions involving corporations: incorporations; reorganizations; and liquidations.

It is important for the taxpayer to know

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(1) With respect to any transaction that may be tax-free, the circumstances which must prevail in order to obtain that status.

(2) The basis to the respective taxpayers of the stock, securities or property involved in the exchange.

(3) The effect of assuming liabilities and when such assumption is permitted.

(4) Whether or not "boot" disqualifies the transaction from being tax-free and, if not, what is the effect of the receipt of boot.

(5) The result on earnings and profits of corporations where part or all of their properties are being transferred.

Incorporations

The first and perhaps the simplest of the exchanges listed above pertains to incorporation. An incorporation contemplates a transfer of property by a person to a corporation in exchange for stock or securities of the corporation, and that the transferor is in control of the corporation after the exchange. For this purpose a person includes individuals, trusts, estates, partnership, associations or corporations. Although tax-free transfers to corporations are generally made at the time of incorporation, such transfers may also be made to existing companies provided the transferor is in control after the transfer. This is so regardless of the fact that the transferor had no interest in the corporation prior to the exchange. Control means ownership of 80% of the voting power and 80% of all other classes of stock.

Where more than one person transfers property, it is not necessary that the stock and securities received by each transferor be in proportion to his interest in the property transferred.

This permits stock and securities to be issued in accordance with the settlements reached through bargaining by the parties involved. Where, however, disproportion arises for reasons other than arms-length bargaining, the proposed Regulations indicate the transaction is to be treated as if the issuance of stock and securities had been in proportion, and then some of the stock and securities had been used in separate and distinct transactions between the transferors. Although the transfer of property to a corporation in exchange for stock or securities would not result in any gain or loss, the parties involved may have tax consequences by virtue of the disproportionate distribution of the stock. Thus, if father and son organize a corporation, each receiving 50% of the voting stock in consideration for which the father contributes 80% of the aggregate of the properties paid in and the son 20%, the excess of 80% over half of the aggregate of the properties is deemed to be a gift by the father to his son.

Similarly, if two individuals receive stock and contribute property in a manner similar to the example cited above and the disproportion in the stock received represents payment for services rendered by one individual to the other, the excess of value of stock received over value of property contributed would be taxable to the party receiving the disproportionate amount. Presumably a like amount would be deductible by other individuals, provided the services were rendered in connection with a trade or business.

The question as to whether stock, or stock and securities (and in the latter case the relative amount of one to the other), should be issued by a corporation in exchange for property should receive careful consideration, as will be seen later when tax-free reorganizations are discussed. There are no specific limitations on the ratio of securities to the aggregate of stock and securities that may be issued by a corporation in exchange for property. After the initial exchange it may be difficult to increase such ratio without incurring a tax liability.

The term "property" includes cash and property of whatever nature, but does not include services rendered to the corporation or to be rendered at a future date. Any stock or securities issued by a corporation for services is taxable to the recipient.

"Boot" is a term applied to property or money received in addition to stock or securities. It is also applied in certain cases to liabilities assumed by a transferee and to the excess of securities issued over securities outstanding prior to the exchange.

In transfers of property for voting control of the corporation it is permissible to transfer liabilities without endangering the tax-free nature of the exchange. There are two exceptions. First, if the purpose of the transaction is to avoid federal income taxes or the exchange does not have a bona-fide business purpose, then the total amount of the liabilities shall be considered as boot received in the exchange. This is so regardless of whether the liabilities are assumed by the corporation or are liens on property transferred. Second, if the total amount of liabilities assumed by the corporation and liabilities which are liens on property exceeds the adjusted basis of the property transferred, such excess is taxable gain to the transferor.

The basis of stock to the transferor is the basis of the property transferred reduced by the boot received and increased by the gain recognized to the transferor. The basis of the property to the corporation is the basis to the transferor plus any gain recognized for tax purposes.

Where there is an exchange of property for stock and the transferor is a corporation, the transferee corporation does not acquire any part of the accumulated earnings and profits of the transferor unless the transfer

is made in connection with a reorganization involving a corporate division as discussed in subsequent paragraphs.

Reorganizations

There are essentially two sections in the Internal Revenue Code which permit non-recognition of gain or loss with respect to exchanges made pursuant to reorganization. The first pertains to stockholders and security holders who exchange their stock and securities for other stock and securities in a reorganization. The second rule pertains to corporations which transfer property in exchange for stock or securities of another corporation involved in the reorganization. In either case the tax-free exchange is predicated on a reorganization and the taxpayers who may treat the transaction as tax-free are parties to the reorganization. It is important that the transaction complies with all technical requirements of reorganization as called for by the Code.

The pattern of the reorganization transactions is divided into six categories, (A) through (F) inclusive, each of which is specifically dealt with in the Code.

Before discussing the specific categories of reorganizations it should be mentioned that, although the Code calls for exchange of voting stock and securities, it is permissible in certain reorganizations to receive other consideration or boot. The receipt of boot may result in either capital gain or ordinary income.

The rule for recognizing gain when boot is involved is simple. Any excess of the sum of market value of stock securities and other property and cash over the adjusted basis of the stock surrendered is gain, and is taxable to the recipient to the extent of the cash and market value of other property (boot) received. Loss is not recognized in an exchange where boot is involved. The gain is taxed to the recipient at ordinary rates up to the stockholder's pro-rata share in the earnings and profits of the corporation accumulated after 1913, and the balance of the gain is taxed at capital gains rates.

There are special rules which apply in connection with Section 306 stock. This is the stock which, when issued as a stock dividend, is tax-free, but results in ordinary income at date of disposition by the shareholder, whether the disposition is by way of sale or redemption. In a reorganization, if common stock is received in exchange for 306 stock, no gain or loss is recognized and the common stock is thereafter not deemed to be 306 stock. If preference stock is received for 306 stock, no gain or loss is recognized at the time of the exchange, but the preference stock is deemed to be 306 stock. Any money or property received in an exchange involving 306 stock is treated as a dividend and taxed in the same manner as a dividend distribution.

The reorganization transactions set forth in the Code are as follows:

(A)—Statutory merger or consolidation:

A statutory merger or consolidation is effected pursuant to state laws. Different states have different laws. It is not always possible to merge or consolidate when various states are involved. For tax purposes it does not matter whether a new corporation is the continuing entity, or whether an existing corporation carries on the business and activities of the merged corporations. Where statutory mergers and consolidations are permitted, it is found generally that there is greater flexibility than if the merger takes place pursuant to one of the other reorganization sections. For example, the continuing corporation may issue securities in addition to its voting stock in a merger where no securities were previously outstanding. In a statutory merger, as in other reorganization transactions, it is permissible for the acquiring corporation

to transfer property directly to a subsidiary which is 80% or more controlled by the company issuing the stock or securities.

(B)—Acquisition by one corporation in exchange solely for all or part of its voting stock of stock of another corporation if, after the acquisition, the acquiring corporation has control:

Again, for this purpose, control means 80% of voting power plus 80% of all other outstanding stock. This type of tax-free exchange can be made even though some voting stock had been acquired for cash in a preceding acquisition. After 80% control has been acquired any further exchanges for voting stock would likewise be tax-free.

For the purpose of a stock for stock acquisition it is permissible to aggregate the acquisitions taking place over 12 months, if such acquisitions are made pursuant to a plan. The pertinent steps in this type of reorganization may be illustrated in the following example.

Corporation P acquired 30% of the stock of Corporation S for cash in 1954 or in a prior year. During January, 1955, P makes an offer to exchange its voting stock for voting stock of S and during the 12 months from date of offering acquires an additional 50%, so that in the aggregate it owns 80% or control of S. The acquisition during the 12 months is deemed to be one transaction, and no gain or loss is recognized with respect to it. Any future acquisitions of voting stock of S for voting stock of P would likewise be tax-free.

In an acquisition of stock for stock there can be no boot. The exchange must be solely for voting stock. Any transfer of cash or other property would destroy the tax-free privilege.

Basis presents a serious problem in a stock-for-stock transaction. Because the exchange is tax-free, the acquiring corporation takes as the basis of the stock it acquires the same basis which the stock had in the hands of the transferor. In many instances the transferors are many individuals. It would not be possible or practical to ascertain the tax basis with respect to each of the individuals; and even though it were possible to obtain the proper data, the question of authenticity would have to be met. Nevertheless, the acquiring corporation should make attempts to obtain the basis of the stock from individuals exchanging large blocks of stock, so that in the aggregate a substantial part of the transferor's basis would be known. A determination of such basis is required if there is a taxable disposition of the stock. Also, the tax basis of assets has significance during periods when an excess profits tax is levied, and in other circumstances where tax basis is called for by the Internal Revenue Code in making determinations having tax significance.

(C)—Acquisition by a corporation of substantially all the properties of another corporation:

If property of a corporation is acquired in exchange solely for all or part of the voting stock of the acquiring corporation, the exchange is tax-free. The stock may be issued to the transferor coporation or to its stockholders. In the latter case it is in effect a merger, even though a statutory merger may not be permitted under state laws applicable to the corporations involved. If the stock is issued to the corporation, the latter becomes a holding company and may continue to exist for other purposes or may liquidate by distributing its holdings to the stockholders.

Under this type of reorganization a parent may be merged into its subsidiary. This is known as a downstairs merger, and takes place when all of the properties of the parent including the stock of the acquiring company are transferred to the subsidiary which, in turn, issues new shares of voting

stock to the stockholders of the parent company.

As previously mentioned, it is important that the technical requirements of the reorganizations be carefully observed. While the statute permits the exercise of judgment, it is in this area that the taxpayers and the Commissioner have many conflicts. In the reorganization under discussion, the Code requires that substantially all of the properties of another corporation be transferred in exchange for the stock. What may seem to be substantial in the eyes of the taxpayer may not be so in the eyes of the Commissioner. It is best to eliminate the hazard of acquiring some, but not all, of the assets, if that is possible. To do so requires the elimination of the assets which are not wanted by the acquiring corporation, or which the stockholders of the transferor corporation desire to keep. Disposition of such assets may be accomplished by (a) sale by the corporation before reorganization; (b) distribution to the stockholders as dividends in kind; or (c) first, transferring such assets to a new corporation for stock and then distributing the stock of the new company to the stockholders. The latter procedure involves a corporate separation, which will be discussed in later paragraphs.

If the unwanted assets are disposed of in one of the ways mentioned, there is no assurance that the tax-free feature of the transaction may not be questioned by the Commissioner. Transactions preceding or succeeding an exchange may be considered as step transactions. Step transactions, when considered as part of an exchange, may either disqualify an exchange which is sought to be made tax-free or may cause a taxable transaction to come within the technicalities of a tax-free reorganization. In many cases taxpayers set the stage in preliminary transactions, so that subsequent transactions will meet the technical requirements. On the other hand, there are many transactions, either before or after a reorganization, which were consummated by the taxpayer without having a reorganization in mind, and the Commissioner may call such transactions step transactions when it is in the government's interest to do so.

There is some freedom of movement where the corporation acquires all of the properties for voting stock, in that it may retain the properties or transfer them to a subsidiary or cause the properties to be transferred directly to a subsidiary. In a direct transfer all of the assets must be transferred together, and stock of only one company may be exchanged for the properties. In an acquisition of property for stock, the acquiring corporation may give boot in addition to voting stock. It is imperative, however, that the voting stock be issued for at least 80% of the fair market value of the property of the transferor corporation. Note that 80% applies to all property, and not merely to the property actually acquired. If the 80% test has been met, the balance of the property may be acquired for cash or for other property.

Where property is acquired solely for voting stock, any amount of liabilities may be assumed without endangering the tax-free status of the exchange. If boot is given in an exchange, then the amount of liabilities assumed and the liabilities which are a lien on the properties are added to the boot for the purpose of determining whether or not the 80% test has been satisfied. The following example may clarify this rule—

Value of assets of transferor	$100,000
Assets acquired	98,000
Liabilities assumed	10,000
Cash boot	8,000
Total boot	18,000
Voting stock exchanged for assets	80,000

The transaction illustrated in the example above would qualify as tax-free, because stock was issued for 80% of the total value of the assets and thus

cash boot of $8,000 is permitted under the circumstances. In any case where the liabilities are equal to 20% of the value of the assets, boot could not be given in an exchange of stock for properties.

While the right to give boot is of considerable importance in acquisitions where minority stockholders of the transferor companies are unwilling to take stock of the acquiring corporation, the limitation placed on the amount of boot is very severe. Steps may be taken to reduce the liabilities and, if all liabilities could be paid off prior to the exchange, it would be appropriate to give cash boot to the extent of 20% of the value of the assets. Care must be exercised when computations are made as the market value of all the assets must be taken into acount and the face amount of all liabilities is likewise taken into account, whether or not they are recorded on the books of the transferor corporation.

(D)—Corporate Separation:

This type of reorganization requires a corporation to transfer property to another corporation for stock or for stock and securities, and to distribute the said stock and securities to its stockholders. The distributees must be in control of the corporation which acquired the properties. The distributee-stockholders may receive such stock or securities without surrendering any of their existing holdings, or they may surrender all or part of their existing holdings. While all or part of the properties of the transferor may be involved, it seems that this type of reorganization will apply generally in cases where only a part of the transferor's properties are put into another company the stock of which is distributed to stockholders of the transferor. This is the reorganization section which permits corporate separation to be effected under rules some of which are definite and some rather indefinite. In the past these separations have been referred to as spin-offs, split-offs and split-ups.

It is in this area that Congress, in the enactment of the 1954 Internal Revenue Code, laid a cornerstone for a structure which permits businesses to be divided free of tax to the stockholders and to the corporations involved. In our business economy, emphasis has been on tax-free transactions that bring businesses together. Such deals can be negotiated with reasonable assurance that no tax will be incurred. We can now begin to think constructively about separating business units. It remains to be seen what interpretations the administrators of our tax laws will place on these newly enacted sections of the Code. Perhaps litigation and amendments to the Code will be required before corporate separation can be planned in the same manner as corporate amalgamations. Plans along these lines will have greater application in the case of the closely-held or family-type corporation than in the case of large publicly-owned companies. When ownership in a business is passed from the founders to the second and third generations, new problems arise which make it desirable for many businesses to separate existing corporate entities. If corporate tax-free separation is not practical, it follows that the only other tax-free route is pursued — namely merger or consolidation.

It should be noted that the reorganization section does not have to be invoked in connection with a corporate separation if the properties which are desired to be separated are already lodged in a subsidiary corporation. If that is the case, the rules regarding distribution of stock of the subsidiary to stockholders are the same as if a reorganization had first taken place.

No gain or loss is recognized to a corporation, or to the stock- or security holders, if a corporation referred

to as a distributing corporation distributes to its stockholders or security holders the stock and securities of a subsidiary (referred to as controlled corporation) which it controls, provided the following three conditions are met:

(1) the transaction was not used principally for the purpose of distributing earnings or profits, either of the distributing corporation or of the subsidiary;

(2) the requirements are met relating to active conduct of a business; and

(3) the distributing corporation distributes all of the stock and securities of the subsidiary held prior to transfer; or it may retain a minority interest of no more than 20% of the voting stock, if it can demonstrate to the satisfaction of the Commissioner that the retention of part of the stock does not have as its purpose the avoidance of tax. The transaction is tax-free, whether or not the distribution is pro-rata and, as mentioned before, whether or not the shareholders surrender any or all of their stock in the distributing corporation and, also, whether or not there is a plan of reorganization.

In the last circumstance, where no plan of reorganization is in existence, the distributing company must hold stock in an existing subsidiary. Where the properties are lodged in an existing subsidiary, the tax-free features of a corporate separation do not apply to the distribution of stock acquired within five years by the distributing corporation in a cost transaction, that is, a transaction in which gain or loss was recognized to the sellers.

Accordingly, as to any subsidiary in which the distributing corporation acquired 80% control in a taxable transaction, no tax-free distribution can be made within five years of acquisition. Once the five-year ownership condition has been met, additional voting stock above the required 80% may be held for less than five years and distribution of the additional stock will not destroy the tax-free distribution of the 80%, but will result in income to the recipient. Stock held for less than five years is treated as boot and taxed to the recipient as an ordinary dividend received from the distributing corporation.

Boot, including any excess of securities received over securities surrendered by holders may be received without jeopardy to the tax-free status, but the receipt of boot is treated as a dividend.

The question as to whether the transaction is a device used to distribute earnings and profits will no doubt result in considerable controversy between taxpayers and the Commissioner. There is no requirement that the recipients of stock hold it for any specified period of time. While Congress may have had in mind a continuity of ownership when corporate separations are permitted without tax consequences, it put no limit on the length of time the distributions are required to be held. The Code and the proposed Regulations specify that the mere fact that there is a subsequent disposition of stock or securities received by a distributee will not be construed to mean distribution of earnings unless such disposition was negotiated or agreed on prior to the distribution.

The requirements with respect to active conduct of a trade or business may be much more difficult to satisfy. Prior to distribution the parent company must either conduct two or more of such businesses or hold stocks in subsidiaries, each of which must in turn conduct such a business.

Each of the businesses that qualifies for tax-free separation must have been actively conducted either by the parent or a subsidiary for a period of five years before distribution. Businesses

which were begun or acquired in a taxable transaction within five years do not qualify.

The Code is silent on what constitutes an active business. The proposed Regulations recite a number of examples illustrating what does and what does not constitute an active business. Such Regulations state that a business consists of a specific group of activities carried on for the purpose of earning income or profits only from those specific activities. It is paramount that the activities include collection of income and payment of expenses. The proposed Regulations indicate that the holding of stocks or securities, land or other property for investment purposes does not constitute an active business; also, the ownership or operation of land and buildings which are used in a trade or business and while necessary to carry on activities of such a business does not constitute a trade or business because that particular activity does not in itself produce income. Among the examples given in the Regulations on activities that do not qualify as active business are:

(1) The holding of investment securities by a manufacturing corporation.

(2) The ownership of factory, buildings used by a manufacturing corporation.

(3) The same business conducted in each of two locations, but the business at one location is owned less than five years.

Among the examples where more than one business exists are:

(1) Ownership of buildings used in part in a manufacturing business and rented in part to outsiders.

(2) Wholesale and retail business where each activity produces income.

(3) The same business conducted in each of two locations, for a period of more than five years.

There are specific rules that must be observed in corporate separations pertaining to the allocation of accumulated earnings and profits of the distributing corporation, which may also affect the earnings and profits of existing subsidiaries the stock of which is distributed tax-free to the stockholders. The accumulated earnings and profits of the distributing corporation immediately before distribution are allocated between the distributing and controlled corporation in one of two ways:

(a) Market value of businesses separated; or

(b) On net basis of assets transferred. (In these circumstances the net basis means the adjusted basis of assets less liabilities).

If the distributing corporation distributes the stock of an existing controlled corporation, then the earnings and profits of the distributing corporation are tentatively allocated as if the stock in the subsidiary had first been transferred to a new holding company. The accumulated earnings and profits of the controlled corporation shall not be less than the amount tentatively allocated as above. If the earnings and profits of the controlled corporation are more than the tentative amount no adjustment is made. If the entire net worth of the controlled corporation is less than the earnings and profits tentatively allocated, then the earnings and profits shall be equal to the net worth and the reduction in earnings and profits of the distributing corporation shall be the amount of such net worth. For this purpose net worth means assets including cash less liabilities. A deficit in earnings and profits of the distributing corporation may not be allocated.

E—Recapitalization:

Among the reorganizations that are permitted to be effected tax-free is the recapitalization of a company. The Code puts no limitations on what can be exchanged in the recapitalization

other than the overall limitations applicable to all reorganizations, which require a business purpose and a plan. The amount of securities that may be issued tax-free to security holders is limited to the amount of outstanding securities exchanged. The proposed Regulations lists four types of exchanges that may be permitted in a reorganization:

(1) An exchange of bonds for preferred stock. (This would give the investors a lower grade of investment.)

(2) An exchange of preferred stock for common stock. (This might give the investors a higher grade of investment.)

(3) An exchange of common stock for preferred stock previously authorized but unissued.

(4) An exchange of preferred stock with dividends in arrears for a similar amount of preferred stock plus stock, either common or preferred, to satisfy the dividend arrearage. (This exchange is not a recapitalization if the effect is similar to the payment of a dividend.)

While under ordinary rules a corporation may issue a stock dividend without tax consequences to the stockholder, there are two exceptions where the general rule does not apply:

(1) In the case where a distribution is made in discharge of preference dividends for the taxable year or for a preceding year.

(2) If the shareholder has an election as to whether the distribution is in stock or in property.

In a recapitalization the first exception to the rule cited above would not apply. The question of business purpose might have to be met by the taxpayer.

F—Mere change in identity, form or place of organization however effected:

A situation where a corporation that might have to change its place of organization or identity is of limited application.

* * * * *

Other non-taxable transactions involving stock, securities and corporations outside of the reorganization field pertain to certain railroad reorganizations, insolvency reorganizations, exchanges and distributions ordered by the S.E.C., and sales or exchanges certified by the F.C.C. These types of reorganization also have limited application.

Liquidations

The receipt of property by a non-corporate stockholder in exchange for stock on liquidation of a corporation is a taxable transaction in every case, and may result in gain or loss to the stockholder. The difference, if any, between the market value of assets received, reduced by the liabilities assumed, and the adjusted basis of the stock surrendered represents the amount of the gain or loss, with one exception. Under this exception property which has appreciated in value may be transferred to a stockholder by a corporation in liquidation without recognition of all or part of the gain on the appreciation.

This exception applies in case of a distribution, pursuant to a plan, in complete redemption of all stock of a corporation (other than a collapsible corporation) wherein the transfer of all property occurs in one calendar month, provided non-corporate shareholders possessing at least 80% of voting stock (exclusive of stock owned by corporations) or corporate shareholders (other than corporations owning 50% or more of the voting stock) possessing at least 80% of the voting stock held by all such corporate shareholders elect to come within the exception. The gain recognized for tax purposes to an electing *non-corporate* shareholder is equal to his pro-rata share of the earnings and profits of the distributing corporation accumulated after February 28, 1913, (the

amount of this gain is treated as a dividend), plus so much of the remainder of the gain (treated as capital gain) as the amount of money or the value of stock or securities (acquired by the corporation after December 31, 1953) received by him is in excess of the amount treated as a dividend. In the case of an electing ***corporate*** shareholder the gain recognized is the greater of (1) the amount of money or value of stock or securities acquired by the distributing corporation after December 31, 1953, which is received by the corporate shareholder or (2) its pro-rata share of the earnings and profits.

The basis of the property received by electing shareholders shall be the same as the basis of the stock redeemed or cancelled in the liquidation, decreased by the amount of money received and increased by the amount of gain recognized for tax purposes.

Liquidations of subsidiary corporations may be effected without gain or loss being recognized to the corporate shareholder, if such shareholder was the owner of at least 80% of the voting stock from the date of adoption of the plan of liquidation until the receipt of the property. Under these circumstances, the distribution in complete redemption of all stock must be completed within three years from the close of the taxable year during which the first distribution is made under the plan.

In the complete liquidation of a subsidiary the basis of the property acquired by the parent is the same as it was in the hands of the subsidiary, except in the case where the parent acquired the stock by purchase within two years preceding the date on which the plan of liquidation is adopted. In such case the cost of the stock in the hands of the parent increased by unsecured liabilities assumed shall be allocated to the assets received (except cash) on the basis of their fair market values on the date received.

Foreign Corporations

All the situations in which the Code permits the non-recognition of gain in exchanges involving incorporation, reorganizations (including a spin-off outside the reorganization provisions) or liquidation apply only when domestic corporations are involved, unless, prior to the exchange, it has been established to the satisfaction of the Commissioner that the exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of income taxes. If the exchange results in a loss which is not recognized for tax purposes it does not matter whether a domestic or a foreign corporation is a party to the transaction.

Generally Accepted Auditing Standards*

(THEIR SIGNIFICANCE AND SCOPE)

The Board of Directors of the Society feels that the growing acceptance by the profession throughout the country of the pronouncements of the Commitee on Auditing Procedure of the American Institute of Accountants, makes it a matter of great importance that all members of the Society be fully informed with respect to them. Accordingly, it has been decided to publish, in serial form, in THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT, *the two principal Institute publications in which they are set forth, namely, "Generally Accepted Auditing Standards, Their Significance and Scope", and "Codification of Statements on Auditing Procedure". The following reprint is the third and final instalment of the former publication.*

STANDARDS OF REPORTING

The ultimate objective of the examination of financial statements by the independent certified public accountant is the expression of an opinion respecting the statements. The report or "certificate" is the medium through which he expresses his opinion on the financial statements subjected to his auditing procedure. In this discussion only the reporting on examinations of financial statements will be considered and particularly the so-called short form of report, reports on special investigations or on other kinds of engagements not being under present discussion.

The financial statements, upon which the auditor expresses his opinion, comprise principally the balance sheet and the statement of income and surplus (the latter being presented also under alternative designations) but they may include other statements as well.

As to the technical authorship of such financial statements, the Codification sets forth the following on page 12:

"Management has the direct responsibility for maintenance of an adequate and effective system of accounts, for proper recording of transactions in the books of account, and for safeguarding the assets. It is also charged with the primary responsibility to stockholders and to creditors for the substantial accuracy and adequacy of statements of position and operations. The transactions with which the accounting records have to do and the recording of those transactions in the books and accounts are matters within the direct or primary knowledge of the company; the independent auditor's knowledge of them is a secondary one, based on his examination. Accordingly, even though the *form* of the statements may show the influence of the accountant—it can only do so if the company accepts, and adopts, the form of disclosure advised by the accountant—the *substance* of the financial statements of necessity constitutes the representations of the company. The independent auditor's representations, therefore, are confined to and expressed in his report, or opinion, upon the statements. The pronouncements of the Institute to this effect have been given the added weight of general affirmation by the Securities and Exchange Commission."

This primary responsibility resting upon the client instead of upon the accountant engaged in the audit of the related accounts must never be lost sight of. A proper understanding of this is indispensable to a proper understanding of the practicality of the accountant's functioning.

To avoid unnecessary duplication, specific reference is herewith made to page 16 of the Codification, for the form and content of the auditor's "certificate"—the common designation of the auditor's short form of report—as in general use in connection with financial statements for publication; it being understood that the matter on pages 15-20 of the Codification is thus to be regarded as effectively incorporated in this special report on auditing standards. As therein set forth, the "certificate" comprises essentially two parts: the "scope" section, with representations as to the auditor's work, and the "opinion" section, expressing his findings upon the financial statements examined; intermediate paragraphs for qualifications or explanations are also often introduced.

Without further comment as to the "scope" section representations—which relate to the area of the "standards of field work"—this discussion will proceed to the area of the accountant's opinion.

The four auditing standards of reporting, as previously given on page 14, are as follows:

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

The long form of report is frequently distinguished from the short form by the inclusion of additional information as to the scope of the work and procedures followed, explanations or details of important items in the financial statements, etc. The standards of reporting, however, remain the same whether the report be the long form or the short form. With the purpose of the independent certified public accountant's report on financial statements in mind, it is evident that the value of the report, whatever its form, depends on its adherence to standards that may perhaps be summarized in the legal maxim of "the truth, the whole truth, and nothing but the truth," if the admonition of "the whole truth" be properly construed as restrictively directed against the "half truth" that gainsays a fair presentation of the facts.

The independent certified public accountant, if the circumstances warrant, must be prepared to refuse the expression of an opinion if he believes that his examination, by reason of restrictions or circumstances, has not been such as to afford him a basis for an informed opinion, or his reservations or exceptions with respect to the financial statements are of such extent that they negative the expression of an opinion.

In formulating his opinion, he must have due regard both for the scope of the examination made and for any exceptions which he considers necessary with respect to the accounting principles followed in the accounting of the issuer of the statements and reflected in the statements. The following formal statement dealing with this subject was approved by the membership at the Institute's annual meeting of November, 1949:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary to express an opinion on the statements taken as a whole. In such circumstances, the independent certified public accountant should state that he is not in a position to express an opinion on the financial statements taken as a whole and should indicate clearly his reasons therefor. To the extent the scope of his examination and the findings thereof justify, he may also comment further as to compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an opinion on the over-all fairness of the financial statements. The purpose of these assertions by the accountant is to indicate clearly the degree of responsibility he is taking.

"Whenever the accountant permits his name to be associated with financial statements, he should determine whether, in the particular circumstances, it is proper for him to (1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a whole. Thus, when an unqualified opinion cannot be expressed, the accountant must weigh the qualifications or exceptions to determine their significance. If they are not such as to negative the opinion, a properly qualified opinion would be satisfactory; if they are such as to negative an opinion on the statements taken as a whole he should clearly disclaim such an opinion. His conclusions in this respect should be stated in writing either in an informal manner, as in a letter of transmittal bound with the financial statements, or in the more conventional short-form or long-form report. However, when financial statements prepared without audit are presented on the accountant's stationery without comment by the accountant, a warning, such as *Prepared from the Books Without Audit,* appearing prominently on each page of the financial statements is considered sufficient.

"It is not contemplated that the disclaimer of an opinion should assume a standardized form. Any expression which clearly states that an opinion has been withheld and gives the reasons why would be suitable for this purpose. However, it is not considered sufficient to state merely that certain auditing procedures were omitted, or that certain departures from generally accepted accounting principles were noted, without explaining their effect upon the accountant's opinion regarding the statements taken as a whole. It is incumbent upon the accountant, not upon the reader of his report, to evaluate these matters as they affect the significance of his examination and the fairness of the financial statements."

With all the facts of a particular case before him, the decision as to the report to be issued is one for the auditor himself to make. It is possible that cases may occur where the accountant's exceptions as to practices followed by the client are of such significance that he may have reached a definite conclusion that the financial statements do not fairly present the financial position or results of operations. In such cases, he should be satisfied that his report clearly indicates his disagreement with the statements presented.

In some cases of extensive exceptions, where an over-all opinion has been disclaimed, it may be possible to express an opinion limited to the items in the financial statements with which the accountant is satisfied. When that is done, however, the report must make clear that no over-all opinion as to position or operating results is intended and the accountant should be careful to indicate

clearly the limitations of such comments to individual items in the financial statements.

Due care also extends to clearly distinguishing between exceptions and explanatory matter or matters of information. Exceptions should be expressed in clearly understandable language and should be as specific as the conditions warrant. Explanatory matter or informatory remarks, preferably given in footnotes to the financial statements, may, however, also be given in the auditor's "certificate."

Rules of Professional Conduct

Pertinent to a discussion of standards of reporting is mention of the Institute's "Rules of Professional Conduct." Paragraphs (5) and (6) state:

"(5) In expressing an opinion on representations in financial statements which he has examined, a member may be held guilty of an act discreditable to the profession if

(a) he fails to disclose a material fact known to him which is not disclosed in the financial satements but disclosure of which is necessary to make the financial statements not misleading; or

(b) he fails to report any material misstatement known to him to appear in the financial statement; or

(c) he is materially negligent in the conduct of his examination or in making his report thereon; or

(d) he fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or

(e) he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances."

"(6) A member shall not sign a report purporting to express his opinion as the result of examination of financial statements unless they have been examined by him, a member or an employee of his firm, a member of the Institute, a member of a similar association in a foreign country, or a certified public accountant of a state or territory of the United States or the District of Columbia."

Adherence to Generally Accepted Accounting Principles

The determination of whether "generally accepted accounting principles" have been adhered to requires the exercise of judgment on the part of the independent certified public accountant, as well as knowledge as to what principles have found general acceptance even though certain of these in manner of application may have received only limited usage. An accounting principle may be found to have only limited usage but still have general acceptance—for example, the sinking-fund principle of depreciation accounting. Moreover, as in all other matters with which the auditor is concerned, materiality is the essence of this standard. The fact that one concern capitalizes certain minor, relatively short-lived items of plant equipment and then depreciates the amount so capitalized, whereas another concern charges off such items forthwith upon purchase or installation, does not operate against recognizing both alike as complying with the depreciation requirement of generally accepted principles of accounting.

In addition to this matter of an accounting principle's being generally accepted even if not generally followed, it is necessary also to bear in mind that

there may be a considerable diversity of practices between different concerns in the application of an accounting principle. Whether with regard to provision for depreciation or provision for losses on receivables or any other matter where there will be general agreement as to the end to be achieved, there may be a considerable lack of similarity in the detailed processes by which those principles are effectuated. Thus, while one concern may follow an accounting procedure distinctly peculiar to itself, this in no way disqualifies it from being accorded a recognition of following "generally accepted accounting principles," if the broad principle which that procedure seeks to implement is, in fact, a generally accepted one.

It is thus important not to regard the matter of "generally accepted accounting principles" from a rigidity of viewpoint that could not possibly comport with the wide variety of operating conditions which will be encountered in business resulting in an equally wide variety of detailed accounting processes.

Observance of Consistency in the Application of Generally Accepted Accounting Principles, Except Where Conditions Warrant Otherwise

Consideration of whether or not accounting principles have received consistent application requires judgment exercise as to whether a change is (a) the proper consequence of altered conditions, (b) a change to a procedure of definite preference in general practice from one not enjoying such preference, though both procedures may be acceptable, or (c) is merely the choice, when two or more alternative procedures are available, of an alternative not dictated by change in circumstances and with possibly ulterior motives. Changes of the last-mentioned type are sometimes adopted merely because they bring about more favorable showings of operating results or presentation. Consistency of application of accounting principles should not be understood as denying a recognition of consistency where changes are made necessary by changes in operating conditions or other governing circumstances.

A phase of the question of consistency in application of accounting principles is that of the significance, or materiality of the effect, of a change. With respect to this the Securities and Exchange Commission in Rule 3.07 of Regulation S-X requires that

"(a) Any change in accounting principle or practice, or in the method of applying any accounting principle or practice, made during any period for which financial statements are filed which affects comparability of such financial statements with those of prior or future periods, and the effect thereof upon the net income for each period for which financial statements are filed, shall be disclosed in a note to the appropriate financial statement.

"(b) Any material retroactive adjustment made during any period for which financial statements are filed, and the effect thereof upon net income of prior periods shall be disclosed in a note to the appropriate financial statement."

Illustrative of a situation which involves a "change" that does not connote inconsistency is a change in the depreciation rate of plant property made because of an increase or decrease in the daily operating hours of that plant. Another is a change in the rate of the provision for uncollectible accounts made because of altered credit conditions.

Adequacy of Informative Disclosures, Whether in the Financial Statements or in the Auditor's Report or "Certificate"

This standard concerns required disclosures that may have to do either with the scope of the auditor's examination or with the financial statements. In the

case of the former, such disclosures may be required only in the "scope" section of the report—where the auditor, for example, having, for some good reason, omitted such a procedure as confirmation of receivables or physical inventory observation or test, has, nevertheless, been able to satisfy himself by other procedures; where such other procedures have not been available, disclosure may also be required in the "opinion" section by way of disclaiming an opinion or qualifying the opinion expressed.

As to the financial statements, fairness of presentation, apart from relationship to generally accepted accounting principles, requires consideration of adequacy of disclosure of material matters, whether relating to the form, arrangement, and content of the financial statements with their appended notes; the terminology used; the amount of detail given; the sufficiency of explanatory or descriptive matter; the classification of items in statements; the bases of amounts set forth, for example, with respect to such assets as inventories and plants; liens on assets; preferred dividend arrearages; restrictions on dividends; contingent liabilities. This enumeration is not intended to be exhaustive but indicative of the nature of the disclosures necessary in order that the financial statements be sufficiently informative.

Mere verbosity in disclosure should not be mistaken for completeness; brevity of disclosure is often more helpful to the discerning reader than amplitude of words. What constitutes material information requiring disclosure in, or in connection with, financial statements is for the auditor to determine in the best exercise of his judgment. That later events may give greater importance to matters that at the time appeared to be of minor consequence does not, of itself, impugn the soundness of his judgment. Foresight and hindsight cannot be admitted to be of equal weight in passing upon conclusions reached at the earlier time; hindsight should be eliminated from the factors by which the soundness of past conclusions are judged. Matters which the auditor deems of such importance as to require disclosure, if omitted from the financial statements or from footnotes thereto, should be included in his report or "certificate," whether these matters be qualifications or necessary explanations.

Disclosure should not be considered to require the publicizing of certain kinds of information that would be detrimental to the company or its stockholders. For example, the threat of a patent infringement suit might impel a conscientious management to set up an ample reserve for possible loss, even though it would expect to fight the issue vigorously; but publicity given to such a loss provision might inure to the harm of the company or its stockholders, for courts have held that a reserve for patent infringement constituted an allocation of infringement profits (where ready determination otherwise was not feasible) notwithstanding a refusal on the part of the company or its management to concede that such an amount might be an equitable allotment of the profits in dispute.

Somewhat related to the matter of disclosure is the subject of information which the auditor receives in confidence akin to the status of privileged communication. Without such confidence the auditor might at times find it difficult to procure information necessary for him in the formation of his opinion upon the related financial statements. If the information thus received, in his judgment, does not require disclosure in order that the financial statements be not misleading, this standard is not to be construed as requiring the divulgence of information which may operate only to the company's disadvantage with no proper, fully compensating advantage to its security holders or creditors.

Various aspects of necessary disclosure have been dealt with in the Codification. Among others, especial mention may be made of pages 21 (3rd and 4th paragraphs), 28, 33-34, and 43-48.

References to Standards in Accountant's Report or "Certificate"

With the differentiation between auditing standards and auditing procedures there is naturally an accompanying recognition that auditing standards, being in the nature of "principles of auditing" are, accordingly, of a breath of extent and application extending beyond that of procedures. Because of this universality of standards, the committee on auditing procedure believes it is more appropriate to speak of "*procedures* considered necessary in the circumstances" than of "*standards* applicable in the circumstances;" in other words, standards as broad statements of governing principles are to be viewed as covering all circumstances, whereas a procedure may be applicable to one case but not to another. As a result of this conclusion the committee believes that expressions such as "necessary in the circumstances" or "applicable in the circumstances" appearing in auditors' reports are related to procedures and not to standards.

COMMITTEE ON AUDITING PROCEDURE
(1953-1954)

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Director of Research

Official Decisions and Releases

STATE OF NEW YORK

DEPARTMENT OF TAXATION AND FINANCE

80 Centre St.

New York City

December 2, 1955

Mrs. Miriam I. R. Eolis, Chairman
Committee on State Taxation, New York State Society of
Certified Public Accountants
c/o A. L. Eolis and Associates
450 7th Avenue,
New York, New York

Dear Mrs. Eolis:

Relative to your letters of October 12, 1955 and October 31, 1955, subject: reproduction of tax returns, I wish to advise you that permission is granted to reproduce forms 3 CT, 3 CT-1, 42 CT, 201, 202, 204, 205, 207 and IT-115.

As was stated in my letter to you of October 26, 1955, the permission for such reproduction will hold until withdrawn. The paper to be used must be of similar color and weight as the official forms themselves.

Very truly yours,

/s/ George M. Bragalini

George M. Bragalini
Commissioner

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Impact of Franchise Tax on a Section 337 Exchange

A corporation sells depreciable property used in a trade or business at a substantial profit. Thereafter it distributes all of its assets in complete liquidation, in accordance with a plan adopted by it. Under the 1954 Code no gain is recognized to the corporation from the sale of the property.

One of our members would like to know if the gain would be subject to the New York franchise tax. There is no specific provision in Article 9A governing this situation. However, Section 208.9 provides that entire net income "means total net income from all sources which shall be presumably the entire net income which the taxpayer is required to report to the United States Treasury Department." This section defining entire net income contains certain enumerated exceptions and a section 377 sale or exchange is not within the exceptions. Consequently this sale or exchange would be recognized as a nontaxable sale or exchange under the franchise tax law.

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928, and a member of the American Institute of Accountants since 1922. He is a member of the New York Bar and Professor of Law at St. John's University.

Mr. Harrow is a past Vice-President of the Society. He is a past Chairman of the Committee on Publications and of the Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

It should be noted that if the distribution was made by a real estate company under Article 9, it would be subject to the additional 2% tax to the extent of the surplus of the corporation.

Deduction for Taxes

A resident is allowed a deduction for all taxes, except inheritance or income taxes paid to any other state or foreign government. Under this provision (Section 360.3), the 5% tax on dividends imposed by Canada on nonresidents would probably not be allowed as a deduction, since that tax has been construed as an income tax by the Internal Revenue Service.

The British dividend tax, however, is a tax on the corporation declaring the dividend and not on the stockholder and so would be deductible. In the latter situation the stockholder would report only the net amount received by him.

Technical Meeting on New York State Taxation

On November 29th the Society held a technical meeting on some phases of New York State taxation, at the Engineering Building. The meeting was under the able direction of Miriam Eolis, chairman of the State Taxation Committee and was very well attended. Three members of the committee delivered formal talks. Sidney Blumenberg, CPA, spoke on assessments, audits and appeals under the income and franchise tax laws. In recent years procedures following the audit of returns have become more formalized. It was therefore appropriate to have a talk on state tax practice. Abraham J. Briloff, CPA, spoke on concepts under the state income tax law governing decedents, estates and

trusts. The speaker emphasized the special problems that must be considered in this area of the income tax law. He considered the problems of the final return for the decedent; the problems of the estate and the beneficiaries; and the problems relating to testamentary trusts. Stanley H. Beckerman, CPA, spoke on the unincorporated business tax.

The members who attended heard three excellent talks and were well rewarded for their attendance. The interest of the members was further evidenced by the questions asked of the speakers and the answers.

Unincorporated Business Tax—Two Businesses Carried on by Same Partners

A and B are partners in a taxi business and also in a car rental business. One of our members wanted to know if each partnership would be entitled to the full salary credit of $10,000 for each partnership and the $5,000 exemption.

A and B are really one entity carrying on two businesses. The regulations require the filing of one consolidated return. Only one salary credit for each partner would be allowed and only one specific exemption. (Regulations—Questions and Answers 6, 7 and 8) However the losses of one business could be offset against the profits of the other. Question 86 dealing with the subject of returns states the requirement that one return must be filed for an entity engaged in more than one distinct business activity. The regulations require the submission however of separate schedules for each distinct business activity.

Unincorporated Business Tax—Buying and Selling Securities

A group of five individuals deposit $1,000 a month with a broker and buy and sell securities as a group. Would such a joint account be considered an unincorporated business and subject to the unincorporated business tax?

An individual, partnership or other entity other than a dealer is not subject to the tax solely by reason of the purchase and sale of property for his or its own account. (Section 386) That word "solely" is troublesome. The Tax Commission defines this to mean that the entity must be engaged only in the purchase and sale of securities to be exempt from the tax. If it does anything else in addition to buying and selling securities, the Commission attempts to tax all the income including the profits on the sale of securities.

Before the amendment of September 19, 1944, to Section 386, the Tax Commission had intimated that if securities were bought and sold for the purpose of making speculative profits, the activities might constitute a taxable unincorporated business, depending upon the continuity, frequency and regularity of the activities, as well as the amount of energy, time and thought involved. Under the amendment there would seem to be no doubt that the purchase and sale of securities for one's own account does not constitute a taxable unincorporated business. Question 22 of the regulations confirms that position. However, a "specialist" in securities is engaged in a taxable unincorporated business and is subject to the tax with respect to all purchases and sales of securities in which he acts as a specialist.

Unincorporated Business Tax—Liquidation of a Business

A, B and C are partners in a ship brokerage business and file their tax returns on a cash basis. A dies and B and C liquidate the old partnership. At the same time they form a new partnership consisting of B and C. Since the old A, B and C partnership merely collects commissions on business consummated prior to A's death and does not "take on" any new business, is the A, B and C partnership still subject to the unincorporated business tax?

The definition of an unincorporated business emphasizes the carrying on of business. Until 1952, the Tax Commission interpreted this to exclude the activity of liquidating a business. The law was amended in that year to include the liquidation of a business as part of taxable business activity. The A, B and C partnership would thus continue to be subject to the unincorporated business tax, until it completely ceases its activity. Since the liquidation does not require the activity of the partners the Commission would probably not allow any deduction for salaries of partners. However the $5,000 exemption would be allowed.

The share of B and C would be excluded from the gross income of A, B and C if such income is included in the unincorporated business tax return of B and C.

In submitting the question our member asks whether the Commission could argue that the firm of B and C is a continuing partnership of A, B and C and therefore that one consolidated unincorporated business tax return would be required, thus limiting the two partnerships to one $5,000 exemption. There is no provision in the law requiring two different partnerships to file one consolidated return. A, B and C, and B and C are two distinct entities. The law does have an exemption provision that will prevent the same income from being taxed twice for unincorporated business tax purposes, but each partnership entity is entitled to the exemption of $5,000.

Unincorporated Business Tax—$5,000 Exemption

A and B are partners in an unincorporated business. A and B are also sole proprietors of their separate businesses. Does each business receive a specific exemption of $5,000? Yes. There are three unincorporated businesses in this set up, and each business is subject to the unincorporated business tax. Each business is entitled to an exemption of $5,000. If the period covered by a return is less than a year. this exemption is prorated to the actual number of months covered in the return.

Since A and B are each separately subject to the unincorporated business tax, the A and B partnership would be exempt from the tax on income distributable to A and to B.

Partnerships and Allocation

A New York partnership has an office only in New York. Its income consists of commissions, 90% of which are earned from work done outside New York State. Is the latter income taxable? The question was asked at the recent technical meeting.

Under the income tax law a partnership is not subject to tax, but the individual partners are taxed on their distributive shares of the partnership income. If the partners are residents of the state they are taxed on income from all sources and the partnership income would be fully taxable to them, even if the partnership did no business in New York and derived no income from New York sources.

If one of the partners was a nonresident, the New York partnership might be entitled to an allocation of its income. But the partnership must have a bona fide office outside the state for the nonresident partner to be taxed on an allocated basis. Otherwise the nonresident partner is deemed to have earned his distributive share from New York sources, even though some of the business of the partnership is of an interstate nature. Professional men who reside outside the state generally may not consider the residence as an office for the purpose of allocating income, unless such office is a bona fide one.

(Continued on page 72)

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

Financial Statements of Brokers and Dealers

Under the Securities Exchange Act of 1934, members of national securities exchanges are required to register with the SEC. Brokers and dealers who trade in the over-the-counter securities markets are also required to register with the Commission. Such members, brokers and dealers must file with the SEC annual reports of financial condition. The financial report must be certified if the member, broker or dealer is required to file a certified financial statement with a state agency in which he does a business as a condition of doing business in securities in that state. Financial statements of members, brokers and dealers must also be certified if the member, broker or dealer extends credit to customers, such as carrying margin accounts or selling securities on a partial payment or installment basis. SEC rules at the present time do not require annual financial reports to be certified if members, brokers and dealers do not extend credit or hold customers' funds or securities except on a temporary basis in connection with a purchase and sale of securities.

It has been suggested that brokers and dealers now exempt from the certification requirements may actually owe money or securities to customers in substantial amounts in connection with their transactions. SEC therefore proposes to extend the requirement for certification of financial reports to all brokers and dealers so that their customers may have the added protection of examination of their financial statements by independent public accountants.

Persons who are interested in the SEC's proposal should submit their views and comments to SEC by January 31, 1956.

Louis H. Rappaport, C.P.A., is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A.'s.

Address of Chairman Armstrong

SEC Chairman J. Sinclair Armstrong spoke before the Houston Chapter of the Texas Society of CPAs on December 7, 1955. The subject of his address was "The Securities Market and the Work of the SEC". Mr. Armstrong talked about recent activity of the SEC particularly with respect to the proposed revision of the proxy rules and the proposed extension of the reporting requirements to unlisted companies. He also discussed the recent revision of Form S-1 adopted in October, 1955. Item 6 of the revised form prescribes the summary of earnings. In some cases, the summary must include interim figures subsequent to the end of the most recent fiscal year. Where such interim figures are furnished, the new instructions provide that figures for the corresponding interim period of the preceding fiscal year shall also be furnished. There is an exception to this rule for public utility companies who may furnish figures for the twelve months ended the latest interim period.

The new rules formalize what was previously an informal administrative requirement with respect to unaudited interim figures. The registrant is required to represent with respect to such unaudited interim figures that all adjustments necessary for a fair statement are included in the interim figures. In addition, the registrant is required to write a letter to the SEC set-

(Continued on page 71)

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

"Change" Forms—Tax Records

Changes in essential data, such as a tax client's address or fiscal year must be made, as promptly as possible, on all pertinent office records. No chance should be taken as to possible neglect of any record. Embarrassments that might develop from such oversights could, sometime, be damaging.

One way to minimize such risks is to use a *"Change Notice—Tax Records"* form. It is prepared by whomever first learns of a change, whether it be a tax department member, the senior accountant-in-charge, a partner, or any other member of the organization. A copy of such a form is on page 68. It will be observed that it lists the common types of changes, the records that require change, and certain administrative control data. Variations of this form may be made to serve individual convenience.

Tax Return Review Efficiency

The review of a tax return has two phases, to wit:

1. Review of the correctness of the figures and other data.

2. Checking compliance with tax law, rules and regulations; tax minimization; adequacy of disclosures.

An accountant can attend to the first phase, but a qualified tax accountant should deal with the second. Qualified tax accountants (tax department personnel, senior accountants) are not as numerous as other staff members, and their time is more restricted and more valuable than that of other staff members. Consequently, a saving in time of the latter group can be accomplished if they are freed from the "figure" review, which is a considerable job in any sizable accounting office.

Accountants who may be interested in instituting such a division of function should consider that the divided responsibility may lead to an indefinite line of demarcation, with attendant problems, unless there is cooperation between the two reviewers and there is a clear indication of the checking done by the "figure" reviewer, particularly.

MAX BLOCK, C.P.A. (N. Y., Pa.) is a former chairman of the Committee on Administration of Accountants' Practice of the New York State Society of Certified Public Accountants. He is a lecturer at The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.

Protecting Tax Returns

Some accountants follow the practice of protecting a tax return that has many schedule attachments by either placing it in a cover, or, backing it with a heavy blank sheet such as is used by attorneys for contracts. Where the papers are very thick, eyelets are used to bind them, otherwise large staples may be adequate.

This is a precaution that all accountants might take where a return with many attachments is involved.

Following Up Individual Taxpayers' Overpayments

Many individual taxpayers are entitled to federal income tax refunds annually, due to the conservatism taken

CHANGE NOTICE—TAX RECORDS

Taxpayer ....Personal Tax Client .... ☐

Change Business Tax Client .... ☐

Address ....

Mailing (Delivery) Instructions...

Fiscal Year ....

Officers ....

New Returns to be Prepared ....

Stop Preparation of All Returns...

....

....

Records To Be Changed	**Disposition of Form**	
Master Tax Card.......	Place in Permanent Tax File	☐
Follow-up Cards	Attach to Last Income Tax Return...	☐
Ticklers	Return to Partner	☐
Mail (Delivery) Card	....	☐
Engagement Record	—o—	
....	Prepared by........... Date..........	
....	Approved by........... Date..........	

in estimating each year's federal income tax liability. While most refunds are applied towards reduction of the next year's estimated tax declaration liability, there nevertheless are many instances where refunds of overpayments are requested.

A service will be rendered the latter group of taxpayers if, when their next year's returns are being prepared, they are questioned about receipt of the refund. This could become a fixed part of tax return preparation procedure.

Accountants who may not want to wait a full year before asking this question might do so by mail or telephone inquiry about five or six months after the return calling for a refund was filed. Thereafter, calls may be made at shorter intervals and, at some point, if the refund has not been received, the accountant may have to suggest, or take, some action. Such short-term follow-up obviously requires a listing of taxpayers entitled to refunds and such other data as may facilitate the control administration.

Payroll Tax Notes

Conducted by SAMUEL S. RESS

Questions and Answers About Unemployment Insurance Law Changes

Through the cooperation of the Division of Employment of the New York State Department of Labor, we have available for distribution among members of the Society and their staffs, the new 16-page brochure, *Questions and Answers about Unemployment Insurance Law Changes,* just off the press. Every C.P.A. and staff man should supply himself with a copy of this most informative booklet. Copies for yourself and the members of your staff may be secured by writing to:

Samuel S. Ress,
Payroll Tax Notes Editor, NYCPA,
2488 Grand Concourse, Room 204 A
New York 58, New York

As the supplies are limited at the present time, please do not ask for more copies than are needed for your own staff requirements. The material will be supplied on a first-come, first-served basis until the supply is exhausted.

We welcome inquiries and requests for assistance in the handling of payroll tax problems from members of the Society throughout the State. Your written queries may be addressed to the writer at the address set forth above, and will receive our prompt attention.

SAMUEL S. RESS, an Associate Member of our Society since 1936, is a member of the New York and Massachusetts Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committee on New York State Taxation and Chairman of the Sub-Committee on Unemployment Insurance.

Representation of Clients at Unemployment Insurance Hearings

While section 538 of the New York State Unemployment Insurance Law appears to indicate that in any proceeding under that statute a party may be represented by an agent, no fees for services rendered by such agent shall be allowable or payable unless such agent is an attorney and counselor-at-law.

As was pointed out by Mr. John L. Carey, Executive Director of the AIA, at the December 12, 1955 meeting of the Society devoted to the subject, "National Problems Affecting New York CPAs' Pocketbooks", a number of government agencies have set up obstacles which make it necessary for the engagement of legal counsel at proceedings before many quasi-judicial bodies, with the certified public accountant in the role of an expert witness when he appears for a client at such hearings. Under the circumstances, accountants should take cognizance of this situation, and where necessary, have qualified counsel called in to present the client's case.

Meeting With Industrial Commissioner Lubin Re: Request Report Penalty

Last month, the writer met with Industrial Commissioner Lubin, Executive Director Brockway, and Director of the Unemployment Insurance Accounts Bureau Green, at which conference ways and means were discussed of solving some of the problems encountered by smaller practitioners and their clients, arising from difficulties in complying with the present 7-day reply requirement of the "LO 12 Request for Employment and Wage Data" from the Division of Employment. The failure to reply within the statutory period generally

results in the imposition of a mandatory $10 penalty for each individual claimant's LO 12 filed late. In rare instances has it been possible to have the $10 penalty cancelled, once the Industrial Commissioner had determined that the delay had not been due to circumstances within the control of the employer.

While the representatives of the Division pointed out that it had been necessary to enforce this provision strictly in order to safeguard against a possible breakdown in existing prompt benefit payment procedures, and to prevent erroneous or fraudulent overpayments, some interest was evinced in the suggestion made by the writer that a change in the statute providing for a permissive, rather than a mandatory, penalty might be of help in difficult situations. The proposal will be explored further.

Apportionment of Remuneration in Connection With Experience Rating

This is the time of the year when requests for apportionment of year-end bonuses, and other lump-sum forms of remuneration paid to employees during the calendar year just past, should be filed with the Division of Employment. The purpose of requesting apportionment of such payments of remuneration in one quarter to be spread over the four quarters of the calendar year, is to minimize the quarterly deviation factor which is an element in the computation of the unemployment insurance rate.

The regulations require that a request for the apportionment of remuneration paid in the form of annual bonuses or other lump-sum payments shall be made in writing on or before July 1st next following the calendar year during which such remuneration was paid. The request must state the total amount of such remuneration paid during each calendar quarter of such calendar year for services performed over a period of more than three months. Under similar conditions, the law permits the apportionment of remuneration paid on a bi-weekly basis resulting in the equivalent of 14 weeks payroll in one quarter and 12 weeks payroll in the quarter following, thereby resulting in a greater quarterly deviation.

Employers of Less than Four Employees and Unemployment Insurance

Accountants are again reminded that employers of three persons in employment *on any one day* during 1956 become subject to the New York State Unemployment Insurance Law. All such employers are required to register with the Division of Employment, obtain an employer account number, and comply with all the reporting requirements and liability for contributions under the Law. Unfortunately many employers learn of their liability after they have incurred heavy penalty and interest assessments with resulting embarrassment to the accountant at the time.

Wage and Hour Law Executive, Administrative, and Professional Exemptions—Changes in Regulations Being Considered

In connection with the December, 1955, hearings conducted by Wage and Hour Administrator Newell Brown, a question has been raised regarding the status of CPAs under the law and regulations. Section 541.3 of the regulations defines the term "bona fide professional" employee as one:

> "(a) whose primary duty consists of the performance of work requiring knowledge of an advanced type in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction and study, . . .; and
>
> (b) whose work requires the consistent exercise of discretion and judgment in its performance; and
>
> (c) whose work is predominantly intellectual and varied in character . . . and is of such character that the output produced

or the result accomplished cannot be standardized in relation to a given period of time; and

(d) who does not devote more than 20 per cent of his hours worked in the work-week to activities which are not an essential part of and necessarily incident to the work described in paragraphs (a), (b), and (c); and

(e) who is compensated for his services on a salary or fee basis at a rate of not less than $75 per week . . . ."

A professional employee paid at a rate of at least $100 per week need not meet tests (a), (b), (c) and (d). The regulations state further that a holder of a valid license or certificate permitting the practice of law or medicine, who is actually engaged in practicing the profession, is excepted from the salary or fee requirement.

While the regulations permit exemption for accountants either by virtue of their professional status or as administrative employees, they must comply with all the other requirements. It is felt that something might be done to include holders of the C.P.A certificate as professionals in the same category as lawyers and physicians.

Accounting at the S.E.C.

(Continued from page 66)

ting forth the adjustments included in such interim figures other than normal recurring accruals. This subject has been discussed in this column previously and is not new to our readers. When the proposed revision was circulated for comment, SEC had a number of interesting comments with respect to those instructions dealing with unaudited interim statements. One person suggested that the required statement as to adjustments be deleted and others that it be qualified in various ways. Mr. Armstrong said that experience has shown that the requirement has caused many companies registering with the SEC to take a "good hard second look" at unaudited interim figures. He continued:

It is common practice for the certifying accountants to assist the registrant in preparing the required letter to the Commission. And of course we assume that the accountants wish to know that the interim periods are prepared on a basis comparable to the certified statements, and, if not, that changes in the application of accounting principles are appropriate. He also wants to be sure that no event has occurred between the date of the certified statements and the effective date of the registration statement that should be disclosed or that should be reflected in the statements he has certified. This Commission places great reliance upon the independent public accountant. This applies to the principles reflected in the uncertified financial statements as well as to the audited statements required to be certified. In a recent case, for example, the accountants' certificate called attention to the fact that the unaudited interim period reflected an important change in accounting. Conferences resulted in a significant change in presentation. "Window dressing" of the type I mentioned a few minutes ago is not confined to offering circulars for small issues. A part of your "reasonable investigation" as certifying accountants prior to the effective date should be directed to uncovering such efforts. The management's statement on adjustments in the prospectus and its letter on this subject to the Commission are required by the Commission for the purpose of assuring that the interim unaudited statements do not suffer from errors of omission or commission.

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Foreign Corporation—Ceasing to do Business

Does a foreign corporation have to continue filing New York franchise tax returns if it gives up its place of business in New York and is generally dormant?

It is assumed that the corporation had originally procured a certificate of authority from the Secretary of State to do business in the state. Under the general corporation law the corporation may surrender the certificate by filing a certificate with the Secretary of State indicating that fact. So far as the formal requirements are concerned that ends the obligation of the corporation to file franchise tax reports.

If the corporation continues to have an officer, agent or representative in New York, it is required to file a special information report (Form 245 C. T.). If the Tax Commission determines on the basis of the information submitted that the corporation is subject to tax it will request the corporation to file a regular franchise tax report.

The question has also been asked whether there are any special forms to be filed if the corporation becomes active again. The corporation may again procure a certificate of authority to do business in the state.

Committee Activities

Committee on Foreign State Taxation

The initial meeting of the Committee on Foreign State Taxation was held on November 3, 1955. Over a hundred members were present to hear representatives of the tax departments of three states address the session, with Leo Mattersdorf, Chairman of the Committee, presiding.

Howard T. Hamilton, Director of the Corporation Division of the Connecticut Tax Department, delivered a concise summary of that state's method of taxing corporations and compared it generally with that of New York.

The intricacies of corporate excess were explained by William A. Schan, a former Commissioner of Taxation for the Commonwealth of Massachusetts. Although now in private practice, Mr. Schan has recently been working with the Tax Commission on revised forms for the 1956 corporation tax, and pointed out ways in which the practitioner might cooperate with the Commonwealth authorities.

The Director of Corporation Taxes for the Commonwealth of Pennsylvania, Charles S. Seligman, explored the "mysteries" of capital stock valuation for franchise tax purposes. Somewhat revised corporate forms are under consideration by Pennsylvania, and Mr. Seligman indicated the lines along which the authorities were thinking, particularly as to balance sheet valuations.

William Kingsley, Deputy Director of the New Jersey Division of Taxation, was unable to attend the meeting, and in his absence Edward J. Kocis of the New Jersey Society spoke briefly on that state's taxing system.

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